Corporate Wire Transfers and the Uniform New Payments Code

Hal S. Scott*

According to 1980 figures, wire transfers—instructions that funds be transferred from one person to another implemented through electronic means—account for the movement of $117 trillion each year.[1] This vastly exceeds the amount transferred by check, $19 trillion, or by bank credit card, $49 billion.[2] The average wire transfer is $2 million, as compared with the average check of $570 and the average bank card transaction of $38.[3] Thus, while the number of wire transactions per year in the United States is quite small in relation to checks or bank credit cards,[4] when something goes wrong on a wire transfer, a great deal more money is typically at stake.

Ironically, however, the payment system transferring the greatest value is governed by a poorly developed framework of legal rules. Other noncash payment systems such as checks and credit cards are governed by a comprehensive body of statutory law or private contractual arrangements. However, due to a lack of statutory coverage[5] and the limited use and scope of private contracts,[6] only a fragmentary body of common law governs wire transfers.[7]

---

* Professor of Law, Harvard University Law School, and Reporter to the 3-4-8 Committee of the Permanent Editorial Board of the Uniform Commercial Code. A.B. 1965, Princeton University; M.A. 1967, Stanford University; J.D. 1972, University of Chicago. This Article is written in my individual capacity and is not intended to represent the views of the 3-4-8 Committee or the Permanent Editorial Board. All citations to the Uniform New Payments Code are to Permanent Editorial Board Draft No. 3, as submitted to National Conference of Commissioners on Uniform State Laws on May 26, 1983. This Draft has not been promulgated or approved by the 3-4-8 Committee or the Permanent Editorial Board. The provisions of this Draft may, of course, be changed by subsequent drafts.

1. Arthur D. Little, Inc., Issues and Needs in the Nation's Payment System 12 (1982) (Table 1) [hereinafter cited as ARCB Report]. This report was prepared for the Association of Reserve City Bankers (ARCB), an association of 400 banking executives representing 160 of the nation's major banking institutions. The author served as Chairman of a Committee of Academic Experts that advised the ARCB and Arthur D. Little on the study.

2. Id.

3. Id.

4. According to the ARCB Report, in 1980, wire transactions numbered 56 million, in comparison with 34 billion checks and 1.3 billion bank credit card transactions. Id. The wire transfer statistics significantly understate wire activity since they are based only on CHIPS and FedWire transactions. BankWire, for example, accounted for an additional 4.8 million transfers in 1980. Id. at 136.

5. Two circuit courts of appeal have held that article 4 of the U.C.C. is not applicable to wire transfers, since a wire transfer is not an "item" under U.C.C. § 4-104(1)(g). Evra Corp. v. Swiss Bank Corp., 673 F.2d 951, 955 (7th Cir.), cert. denied, 103 S. Ct. 377 (1982); Delbrueck & Co. v. Manufacturers Hanover Trust Co., 609 F.2d 1047, 1051 (2d Cir. 1979); cf. Houston Contracting Co. v. Chase Manhattan Bank, 539 F. Supp. 247, 249 & n.2 (S.D.N.Y. 1982) (assuming that a wire transfer may be an "item" under § 4-104(1)(g) but holding that it is not a "demand item"). But see Securities Fund Servs. v. American Nat'l Bank and Trust Co., 542 F. Supp. 323, 327 (N.D. Ill. 1982); French Bank v. First Nat'l Bank, 585 S.W.2d 431, 432 (Ky. Ct. App. 1979); Clarke, An Item is an Item is an Item: Article 4 of the U.C.C. and the Electronic Age, 25 Bus. Law. 109 (1969). All citations to the U.C.C. are to the 1962 Official Text.

6. See infra notes 56-61 and accompanying text.

7. See infra notes 62-72 and accompanying text.

This anomaly in the law of commercial transactions is a matter of substantial concern to the banking community.[8] It also creates the risk that courts will lack adequate guidance in deciding cases in this uncharted area and increases unnecessarily the uncertainties and risks faced by the parties to wire transfers.

The 3-4-8 Committee of the Permanent Editorial Board of the Uniform Commercial Code (U.C.C.)[9] recently issued for public comment Permanent Editorial Board Draft No. 3 of a proposed Uniform New Payments Code (N.P.C.). The Draft was presented for a first reading at the July 1983 annual meeting of the National Conference of Commissioners on Uniform State Laws.[10] The N.P.C. is intended to provide a comprehensive legal framework for all types of noncash payments.[11] It would replace most of both article 4 of the U.C.C. and the Electronic Fund Transfer Act of 1978 (EFTA)[12] and would supersede article 3 of the U.C.C. to the extent article 3 applies to checks and drafts.[13] The N.P.C. attempts to systematize the legal framework governing

---

8. The ARCB Report concluded that the "development of a body of law" in this area is an important policy matter for the banking industry. ARCB Report, supra note 1, at 25. The development of a body of law is also an international problem as well as a problem in other countries. See United Nations Commission on International Trade Law, Report by the Secretary-General, Electronic Funds Transfer, U.N. Doc. A/CN.9/221 (1982).

9. The 3-4-8 Committee, chaired by Robert Haydock, Jr., has 11 members including bank lawyers, lawyers involved in consumer advocacy, and academics. The 3-4-8 Committee is jointly sponsored by the National Conference of Commissioners on Uniform State Laws and the American Law Institute.

10. There must be at least two readings before the Commissioners can approve the N.P.C. National Conference of Commissioners on Uniform State Laws, Constitution §§ 8.1, 8.2, 8.3, printed in Handbook of the National Conference of Commissioners 254, 260–61 (1979). The membership and Council of the American Law Institute also must approve the draft. American Law Institute, Bylaws, Part V, 58 A.L.I. Proc. 667, 672 (1981). In addition to formal approvals, the 3-4-8 Committee is actively soliciting the ideas and criticisms of various banking and bar committees. Three committees of the American Bar Association Section of Corporation, Banking and Business Law—the Uniform Commercial Code and Consumer Financial Services Committees and the Ad Hoc Committee on the Uniform New Payments Code—and committees of the American Bankers Association, the New York Clearing House Association and the Federal Reserve Banks are actively reviewing the progress of the N.P.C.

The N.P.C. has been under consideration since 1977 and has been the subject of extensive deliberation by the 3-4-8 Committee. See Scott, The Risk-Fixers, 91 Harv. L. Rev. 737 (1978); P. Murray, Paper Problems Under Articles Three and Four: A Report for the 3-4-8 Committee (June 19, 1979); H. Scott, New Payment Systems: A Report to the 3-4-8 Committee of the Permanent Editorial Board for the Uniform Commercial Code (Feb. 8, 1978).

11. The N.P.C. applies to all noncash payments, including payment by wire, check, credit card, debit card, automated teller machine, home terminal, telephone and by preauthorized transfer through automated clearing houses. The N.P.C. is intended to cover the relationships among the various parties to funds transfers as well as claims by third parties such as attaching creditors.

12. 15 U.S.C. §§ 1693–1693r (Supp. V 1981). The EFTA has been implemented by Regulation E, 12 C.F.R. §§ 205.1–.14 (1983) (issued by the Federal Reserve Board). See also Official Staff Interpretation of Regulation E, 12 C.F.R. part 205, EFT-2 (1983).

13. The N.P.C. would also replace provisions of the Truth in Lending Act (TILA) applicable to lost or stolen card liability, error resolution and disclosures other than those concerning "finance charges" and "periodic rates." If the N.P.C.'s provisions differ from those of existing federal law, they will have to be enacted, at least in part, at the federal level. Federal law now imposes a mandatory structure on contractual relationships between "consumer" customers and their banks for credit card transactions under the TILA, 15 U.S.C. § 1643 (Supp. V 1981), and for certain electronic funds transfers under the EFTA. Federal law also governs the use of certain

all modes of noncash payment, including wire transfers, so that, to the greatest extent possible, the same legal consequences attach in a given transaction regardless of the method of payment used.[14] Of course, the nature of the transaction or of the technology employed may, for quite good reasons, require different results. However, the N.P.C. represents the first attempt to compare, cross-justify and consolidate such payment system rules on a systematic basis.[15]

This Article discusses the provisions of the N.P.C. that cover corporate wire transfers—transfers in which both the originator and recipient are business firms.[16] Given the lack of a clear and systematic legal framework now covering wire transfers, these provisions should make a significant contribution to the development of commercial law by providing a coherent legal framework that will resolve serious legal problems in an area of great commercial and financial importance.

The Article is intended to give practical guidance on the N.P.C.'s treatment of particular problems that may arise in wire transactions, and it may be instructive to parties to transfers and to the courts even before the final adoption of the N.P.C. Parties may seek to structure risks and obligations along the lines suggested by the N.P.C. through private contractual arrangements. If a difficult case involving wire transfers should arise, the reasoning of

---

Federal Reserve payment systems, such as FedWire and Fed check collection, see Regulation J, Subparts A and B, 12 C.F.R. §§ 210.1-.38 (1983), as well as payments made by the federal government, see, e.g., Federal Recurring Payments Through Financial Organizations by Means Other than by Check, 31 C.F.R. §§ 210.1-.11 (1982). If the N.P.C. is enacted as federal law, it will apply fully to the federal government as a participant in and provider of payment services.

14. Differences among the rules governing different payment systems currently follow no justifiable pattern. For example, the U.C.C. provides that check writers are not liable for forged check losses unless they are negligent. U.C.C. §§ 3-401, 3-406, 4-406. Under the TILA, 15 U.S.C. §§ 1601-1691f (1976 and Supp. V 1981), credit card users can only be liable for up to $50 of the loss, even if they are negligent. See 15 U.S.C. § 1643 (Supp. V 1981). Consumer on-line debit card users can be liable under the EFTA, see 15 U.S.C. §§ 1693-1693r (Supp. V 1981), for up to $50, $500 or the entire loss, depending on whether the loss of a card is promptly reported, see 15 U.S.C. § 1693g (Supp. V 1981). The reference is to "on-line" debit cards because a batched debit card, like the current VISA card, which initiates a transaction by an imprinter and is batched for collection, is not an "electronic fund transfer" under the EFTA since it is not "initiated through an electronic terminal." 15 U.S.C. § 1693a(6) (Supp. V 1981). There are no statutory rules regarding negligently or fraudulently originated wire transfers.

These anomalies are due in part to the fact that these rules were formulated at different times. Checks were first covered by the U.C.C. in the 1950's. Credit cards are covered by the TILA, which was enacted as part of the Consumer Credit Protection Act in 1968. Pub. L. No. 90-321, 82 Stat. 146 (1968) (The liability rule discussed above was enacted as an amendment to the TILA in 1970. Pub. L. No. 91-508, § 502(a), 84 Stat. 1126 (1970).). Finally, the EFTA addressed on-line debit cards in the late 1970's. Pub. L. No. 95-630, 92 Stat. 3728 (1978).

15. This result has already been achieved for various types of secured transactions under article 9 of the U.C.C., which replaced disparate state chattel-mortgage, factors-lien, conditional-sale, and trust-receipt statutes with its concept of a unified security interest. See 1 G. Gilmore, Security Interests in Personal Property § 9.1 (1965). Legal factors, such as required documentation, finality and availability, clearly influence consumer choices of payment systems. See Hirschman, Consumer Payment Systems: The Relationship of Attribute Structure to Preference and Usage, 55 J. Bus. 531 (1982).

16. The N.P.C. has special provisions applicable to wire transfers in which consumers are party to the transaction. Analysis of such transfers is beyond the scope of this Article.

the N.P.C. could provide persuasive guidance to the court deciding the case. In the vacuum that now exists, a discussion of the N.P.C.'s proposed rules will improve parties' and courts' understanding of the legal issues presented by wire transfers.

The principal objective of this Article, however, is to stimulate informed discussion of the N.P.C. in the legal community. The N.P.C. is far from settled and enacted law, and its current provisions are subject to change as comments and criticisms are received by the 3-4-8 Committee and reflected in future drafts. The comprehensive coverage of the N.P.C. makes it essential that the broadest possible spectrum of interested parties analyze its provisions so that they may be further improved. While the Article discusses only corporate wire transfers, it is hoped that by analyzing the N.P.C.'s operation in a particular area, the Article will help illuminate the general manner in which the N.P.C. is intended to operate and the rationales and policy choices underlying its provisions.

Part I provides some general background about wire transfer systems and the legal framework in which they currently operate. It concludes that neither private contracts nor existing common law are adequate to structure the major risks that arise through this method of payment.

Part II discusses six major issues in the law of wire transfers and the resolution of those issues under the proposed N.P.C. First, it develops the fundamental distinction between "pay order" transactions, like wires, that *push* funds and orders to payees at the same time, and "draw order" transactions, like checks, that split the transfer of the order and the collection of funds. The payee of a check receives the order and then *pulls* funds from the drawer through the check collection process. Since the payee on a pay order receives the funds directly and never "takes" or possesses the order itself, the mechanics, risks and legal problems posed by pay orders differ significantly from those posed by draw orders.

Second, it explores the N.P.C.'s treatment of the obligation of parties to pay on properly authorized and unaltered orders. Absent contrary private arrangements,[17] the N.P.C. imposes on the parties to a wire transfer basic contractual obligations concerning the payment of authorized orders. These contracts allocate the risk that arises when the payee or the payee's bank does not actually receive the funds represented by the wire. These provisions would supplement the existing rules governing transfer systems, which are almost exclusively concerned with the risks to be borne by the systems themselves, and which fail to address systematically the risks and liabilities of the parties to transfers.

Third, it analyzes the N.P.C.'s treatment of three related questions: (1) when is a transfer instruction from the sender's bank to a subsequent party "final," so as to make the sender's bank responsible for actually making

17. The N.P.C. includes liberal provisions allowing parties and transfer systems to contract out of the N.P.C.'s requirements. See infra notes 228–36 and accompanying text.

payment; (2) when does the payee have the right to withdraw the funds represented by the wire; and (3) under what circumstances can the payee's bank revoke any credit given to the payee on the basis of the wire? These issues are central to the determination of the risks, liabilities and defenses of each party to a transfer.

Fourth, it discusses the N.P.C.'s treatment of the liability of transmittors for the negligent or intentional mishandling of "authorized" transfers—transfers that have been properly initiated or authorized by the drawer and whose terms have not been altered materially. In cases involving authorized transfers, the N.P.C. places significant limits on the availability of consequential damages against both the payor's bank and subsequent transmittors of the order.

Fifth, it describes how the N.P.C. allocates losses from fraud and mistake on "unauthorized" wire transfers. Under the N.P.C., an order is "unauthorized" if it is initiated without the drawer's consent or is materially altered in transmission.[18] The N.P.C. includes provisions addressing both the substantive liability principles that allocate risk and the causes of action that enforce these liability principles. The N.P.C. treats fraud and mistake as "accidents" that are inevitable in a complex wire transfer system and uses tort principles to allocate the resulting risks. Contract principles are ill-suited to allocate risks among multiple parties in no contractual relationship.

Finally, Part II examines the extent to which parties are free to contract out of the N.P.C.'s statutory rules, and concludes that broad latitude is generally appropriate. In this sense the N.P.C. does not impose a mandatory regulatory scheme, but, like the U.C.C., is intended only to provide a "backstop" legal framework—controlling in the absence of contrary private arrangements. The N.P.C.'s provisions would not displace privately established rules governing funds-transfer systems. Instead, the N.P.C. would only supplement these existing system rules by addressing issues that they do not cover or cover inadequately.

I. General Background on Wire Transfers

Wire transfers between two banks originate in several ways. A corporate treasurer may telephone a bank and ask it to transfer funds to the account of another firm at another bank. Alternatively, he may use a terminal linked to his bank's computer. Occasionally, transfers originate on the basis of written instructions. Wires may also be prearranged either on a repetitive basis, as when a firm instructs its bank to make monthly fixed payments to another party, or on a zero- or target-balance basis, as when a firm instructs its bank to sweep extra balances into short term money market investments or into a concentration account at another bank. Banks, or other depository institu-

18. N.P.C. § 54(1).

tions, also send wires to other banks to settle interbank obligations, or to the Federal Reserve to replenish their reserve or clearing accounts.

A. *Wire Transfer Systems*

Wires move over various communication systems, some of which provide for specific means of settling interbank obligations created by the transfers. The principal wire systems are FedWire, BankWire II, CashWire, CHIPS, S.W.I.F.T. and telex.

A brief review of these systems brings out four points. First, systems like S.W.I.F.T., BankWire II and telex, which provide only a communications network and leave settlement arrangements to the parties, differ from systems like FedWire, CHIPS and CashWire, which establish specific settlement rules in addition to providing a communications network. Second, the settlement risks differ among net settlement systems, like CHIPS and CashWire, which defer settlement to the end of a specified period; bilateral settlement systems like FedWire, in which settlement occurs at the time of the transfer; and communications networks like S.W.I.F.T., BankWire II and telex, which establish no settlement rules but rely on correspondent accounts.[19] Third, system rules fail to provide adequate solutions to the *ultimate* liability of participants, or their customers, for failures to settle obligations, fraud or mistake. Fourth, participants are unable to shape rules governing FedWire and telex, which are not owned and controlled by their users.

1. *FedWire*. FedWire is a communication and settlement system owned and operated by the twelve Federal Reserve Banks.[20] Unlike a telex, for example, which only transmits the instruction to pay, a FedWire transmits both the message and the underlying funds. Thus, the Fed participates directly in the settlement of interbank obligations and provides settlement services as well as communication services.

The rules governing FedWire are contained in Subpart B of Regulation J[21] issued by the Board of Governors of the Federal Reserve System, as supplemented by operating circulars issued by each local Federal Reserve Bank.[22] Regulation J provides that the Fed is liable for all losses, including

---

19. If Bank One sends a wire to Bank Two and has a correspondent account with Bank Two, settlement can occur by Bank Two debiting Bank One's account. Alternatively, Bank One could send a FedWire to Bank Two or to another bank holding an account of Bank Two.

20. See generally ARCB Report, supra note 1, at 146–49.

21. 12 C.F.R. §§ 210.25–.38 (1983).

22. See, e.g., Federal Reserve Bank of New York, Wire Transfers of Funds (Operating Circular No. 8, rev. ed. 1980). Interdistrict communications are currently routed through a central switch in Culpepper, Virginia, but the system is in the process of converting to a "packet switched" network that permits messages to travel through three alternative switches and thereby increases capacity and speed of execution. See ARCB Report, supra note 1, at 147; Corrigan, The Fed: Regulator or Competitor in the Payments System?, Am. Banker, March 6, 1981, at 24, 52; Background Materials for E. Gerald Corrigan, Remarks before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs and the Subcomm. on Commerce, Consumer and Monetary Affairs of the Comm. on Government Operations V-40 (June 16, 1983) [hereinafter cited as Background Materials].

consequential damages, caused by its lack of ordinary care or good faith.[23] The Fed is responsible, however, only to the transferor for mishandling a payment instruction. No attempt is made to specify the liabilities of other parties.[24] Since FedWire is governed by federal regulations, parties cannot contract out of the provisions of Regulation J or alter FedWire rules.

Since 1980, any "depository institution" has been able to use FedWire to transfer funds from a reserve or clearing account[25] held with its local Federal Reserve Bank to the account of another depository institution[26] at the latter's Federal Reserve Bank. A nondepository institution can access FedWire through a depository institution.

Settlement in FedWire is bilateral. The Fed debits and credits Fed accounts on each separate message moving through the system. While the Fed may permit some senders of FedWires to overdraft their accounts during the day, the finality of a FedWire payment is not conditional on the sender's covering the "daylight" overdraft. Regulation J provides that a transfer is "finally paid" when "the transferee's Reserve Bank sends the transfer item or sends or telephones the advice of credit for the item to the transferee, whichever occurs first."[27] Since the credit to the recipient depository institution's account is not conditional and occurs almost simultaneously with the receipt of the transfer instruction by the Fed, and because it is practically impossible for a Reserve Bank to fail, FedWire credits are "good funds." Indeed, they are the best funds a transferee can have.

2. *BankWire*. BankWire is owned by 200 commercial banks that are members of the Payment and Administrative Communications Corporation (PAC). PAC offers a communication service, BankWire II, and, as of 1982, a communication and net settlement service, CashWire, to any "depository institution."[28]

---

23. 12 C.F.R. § 210.38 (1983).

24. Id.

25. A reserve account holds reserves required by the Federal Reserve Board. Regulation D, 12 C.F.R. § 204.3(b)(2) (1983). A clearing account holds a "compensating" balance in excess of required reserve balances. The Fed pays earnings credits at the weekly average federal funds rate on this balance. The credits can only be used to pay for Fed services. See Background Materials, supra note 22, at VI-4 to VI-6. A depository institution, see infra note 26, which is not required to hold reserves, may still have an account with the Federal Reserve to clear payments.

26. Section 19(b) of the Federal Reserve Act, as amended by the 1980 Depository Institutions Deregulation and Monetary Control Act (MCA), Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified at 12 U.S.C. § 461(b) (1976 & Supp. V 1981)), defines a "depository institution" as any institution that is insured or insurable by the Federal Deposit Insurance Corporation, or is insured by the Federal Savings & Loan Insurance Corporation, or National Credit Union Administration Board. Section 11A of the Federal Reserve Act, as amended by the MCA, provides that Federal Reserve Bank services, including wire transfer services, are to be provided for a charge to such depository institutions. 12 U.S.C. § 248a (1976 & Supp. V 1981).

27. 12 C.F.R. § 210.36(a) (1983).

28. ARCB Report, supra note 1, at 134; B. Romberg, President, PAC, and S. Rosen, Vice-President, Citibank, N.A., Presentation on BankWire Net Settlement delivered at the Money Transfer Conference sponsored by the Bank Administration Institute (1982) (cassette tape on file at the offices of the Columbia Law Review).

BankWire II, which is not a settlement system, has no rules other than those specifiying formats and standards for sending messages, and makes no express provision for the legal consequences of not following these rules. The participating banks handle settlement through debits and credits to correspondent accounts. Thus, the sending member can either credit the receiving member's account, if it holds one, or send money to an account of the receiving bank, by, for example, a FedWire. Alternatively, the receiving member can debit the sending member's account if it holds one.

The rules of CashWire,[29] which combines communication and settlement services, do not allocate risks other than those arising from the failure of a bank to settle. Users place restrictions on messages they are willing to receive in order to limit their exposure. Recipients can choose to accept messages only from specified senders and must set a maximum "net" credit position allowable for each of those senders.[30] Thus, for example, Bank *A* may determine that it will not accept Bank *B*'s messages that exceed on net—messages from *B* to *A* are netted daily against messages from *A* to *B*—$50 million. In addition, at no time may a participant's "net debit balance"—the amount by which the sum of a participant's system debits exceeds the sum of its system credits—exceed certain percentages of assets or capital.[31]

At the end of any given day, Day One, CashWire supplies to the Federal Reserve Bank of New York (N.Y. Fed) a settlement statement showing the debits and credits to be made to the accounts of the participants at their respective Reserve Banks.[32] On the instructions of N.Y. Fed, the appropriate Reserve Bank will then "provisionally"[33] post these debits and credits to the Fed accounts of customer banks. Assuming all participants have sufficient collected balances in their Fed accounts, settlement becomes final by 9:00 a.m. on Day Two.[34] If, however, a bank has failed or, in the judgment of a Reserve Bank, will fail to cover its net debit position, this position is covered by apportioning settlement obligations among all banks in a net credit balance with the nonsettling bank.[35] Thus, if Bank *A* fails to cover a net debit settlement obligation of $1 million to the system, and Banks *B* and *C* are net creditors of Bank *A* to the extent of $2 and $8 million respectively, Bank *B*

29. The rules governing CashWire transactions are promulgated by the Board of Directors of the Payment and Telecommunication Services Corporation (PTS), the wholly owned operating subsidiary of PAC. Interestingly, the agreement between the Fed and PTS for settlement of CashWire transfers provides that neither Regulation J nor the U.C.C. are to apply to any "Settlement Statement or any other message issued in connection therewith by a Bank." Terms of Settlement by Federal Reserve Banks for Banks Relating to BankWire Transactions para. 11 (effective September 2, 1982) [hereinafter cited as Fed-BankWire Agreement].

30. BankWire, Rules Governing the BankWire Net Settlement System para. 6 (1982) [hereinafter cited as CashWire Rules].

31. Id.

32. Id. para. 7(a).

33. Id.

34. Id. para. 7; Fed-BankWire Agreement, supra note 29, para. 8.

35. CashWire Rules, supra note 30, attachment C; BankWire, CashWire Presentation Guide 3 (1983).

will cover $200 thousand (2/10 x $1 million), and Bank *C* will cover $800 thousand (8/10 x $1 million) of Bank *A*'s $1 million deficit. As a result of this apportionment, *B* and *C* would become creditors of *A* to the extent of the adjustments. If *B* or *C* cannot cover *A*'s position, the N.Y. Fed has the discretion to refuse to make any settlement, and the participants will be left to their own devices to settle their net positions with each other.[36]

3. *CHIPS*. The Clearing House Interbank Payment System (CHIPS) is owned and operated by the New York Clearing House Association, an organization composed of the twelve major New York City banks. CHIPS is a communications and net settlement system for payments made by and to two classes of participant banks located in New York City: "settling" and "nonsettling" participants.[37] All participants, 98 of which are now active, can send transfers to other participants through a central CHIPS switch linked to their own terminals and computers. Only 22 of the participants are settling participants; these banks settle their own positions as well as those of other participants on whose behalf they act.[38]

Settlement is effected, under an agreement with the N.Y. Fed,[39] on the same day as the relevant transactions.[40] CHIPS provides a net settlement report to each settling participant by 4:45 p.m. on each business day. Net debtors must then send FedWires to the N.Y. Fed to cover their positions. When all debtors have settled, the N.Y. Fed, through CHIPS as agent, sends FedWires to the creditors. The process is completed by 6:30 p.m.[41]

A settling participant may refuse to settle on behalf of one of the nonsettling participants either because the nonsettling participant has not covered its position with the settling participant or because the settling participant is not willing to assume the credit risk of an uncovered position. If no other settling participant covers the position of the participant failing to settle (the "failed" participant), all transfers by and to that "failed" participant are deleted from a subsequent net calculation.[42] Unlike the CashWire system, the net debit position of the "failed" participant is not apportioned among its net creditors. After deletion, all net creditors are left to private arrangements to resolve their claims. Settling participants also may be unable to settle their own positions, and the same deletion rules would apply.[43] If there is a failure

36. Fed-BankWire Agreement, supra note 29, para. 9.

37. ARCB Report, supra note 1, at 137.

38. Telephone interview with Seymour R. Rosen, Vice President of Citibank, N.A. (Feb. 4, 1982).

39. CHIPS Settlement Agreement, Letter from Thomas C. Sloane, Senior Vice President and Senior Adviser, Federal Reserve Bank of New York, to John F. Lee, Executive Vice President, New York Clearing House Association (Aug. 14, 1981) [hereinafter cited as CHIPS Settlement Agreement].

40. Id. paras. 3, 4.

41. Rules Governing the Computerized Clearing House Interbank Payments System para. 13 (amended July 22, 1981; effective Sept. 11 and Oct. 1, 1981) [hereinafter cited as CHIPS Rules]; ARCB Report, supra note 1, at 139.

42. CHIPS Rules, supra note 41, paras. 13b, 13d.

43. Id.

in settlement, the N.Y. Fed, under its agreement with CHIPS, is under no obligation to supply credits,[44] although the N.Y. Fed might, of course, settle the shortfall to avert a financial catastrophe.

Rules promulgated by the New York Clearing House govern transfers through CHIPS. Apart from detailing the settlement obligations already described, the rules address some of the problems that may occur as a result of fraud or mistake. In general, however, the rules fail to fix the obligations of the participants; they are principally concerned with the risks and liabilities to be borne by the CHIPS system itself. Any loss of funds caused by a "system" error—an error that originates at the Clearing House—is to be settled directly between the participants involved, without any responsibility on the part of CHIPS.[45] Nonsystem errors, such as payments made to the wrong bank, are to be referred to the rules of the Council on International Banking,[46] which provide for compensation for lost interest, but make no provision for recovery of lost principal.[47] Any loss due to a fraudulent transfer is borne by the entity from which the fraud originated—a participant or the Clearing House as the case may be.[48] However, the maximum liability of CHIPS is $25 million for each unrelated incident, the maximum limit of its own insurance policy. Over this amount, all participants in the system share the loss prorata, based on average daily usage of CHIPS.[49]

4. *S.W.I.F.T.* The Society for Worldwide Interbank Financial Telecommunication (S.W.I.F.T.) is an international communications system for wire transfers among approximately 900 member organizations, including nondepository institutions, from thirty-nine countries.[50] The S.W.I.F.T. communications network covers all of North America, Japan, Western Europe, and certain countries in Latin America and Southeast Asia. Three operating centers—located in Belgium, the Netherlands, and the United States—support the system, with regional processors located in nearly all member countries. The operating centers function as the focal points in the system, since they are interconnected and process transactions between sending and receiving banks.[51]

International data transmission lines connect the operating centers to regional processors. In turn, individual members are connected by national

---

44. Id. para. 4.

45. Id. para. 15. See generally Comment, Risk Allocation in International Interbank Electronic Fund Transfers: CHIPS & SWIFT, 22 Harv. Int'l L.J. 621 (1981).

46. CHIPS Administrative Procedure No. 2 (October 29, 1970).

47. Council on International Banking, Interbank Compensation Rules, appendix B, effective November 1, 1977, reprinted June 20, 1980 (incorporating all amendments and effective interpretations).

48. CHIPS Rules, supra note 41, para. 15.

49. Id.

50. ARCB Report, supra note 1, at 17. S.W.I.F.T. is a Belgian not-for-profit cooperative in which members vote for directors in proportion to their traffic over the system. Countries with at least 2% of the traffic each have one seat, while countries with more than 6%, such as the United States, have two board members. Id. at 142.

51. ARCB Report, supra note 1, at 142–43.

communications facilities to the regional processors. Each regional processor acts as the point in a particular country through which transactions flow to and from the operating centers.

Settlement of S.W.I.F.T. transactions is left to separate arrangements among the parties. However, S.W.I.F.T. does establish rules for the apportionment of certain other risks. Participants are responsible for the content of messages and for the security of transmission lines between participants and their regional processor.[52] However, no rule apportions losses among participants if these obligations are not met. S.W.I.F.T. assumes liability for direct losses of up to 1 billion Belgian Francs (approximately $20 million)—the maximum insurance coverage, subject to certain deductibles—for each loss or series of losses arising out of negligence or fraud committed by S.W.I.F.T. employees.[53] Losses above 1 billion Belgian Francs are apportioned among the particular participants making claims to recovery. Where, due to delays in processing, parties do not receive transfers on time, S.W.I.F.T. also establishes rules apportioning the interest costs of late payments among S.W.I.F.T. and the participants in the transaction.[54]

5. *Other Transfer Systems.* Instructions to transfer funds also move over public networks, such as telex,[55] that are not dedicated to processing such messages. These systems have no settlement rules and are unlikely to have any rules for apportioning losses due to fraud or mistake except to limit the liability of the proprietor of the system.

B. *The Legal Framework*

1. *Private Contract.* The private rules of the wire transfer systems do not provide an adequate legal framework for structuring the rights and responsibilities of parties to wire transfers. First, these rules do not purport to govern the relationships between the originators or beneficiaries of wire transfers and their respective banks; these relationships are governed by contracts between banks and their customers. A recent Bank Administration Institute survey shows that such contracts often do not exist and, even if they do, frequently fail to allocate significant risks among the parties.[56]

---

52. S.W.I.F.T., User Handbook §§ 7, 2.2, 2.3 (1979).

53. Id. § 7, ch. 7.2.2.3 (deductibles outlined § 7, ch. 7.2.2.4).

54. Id. § 7, ch. 7.1.3; see also Comment, supra note 45.

55. Telex is a hard copy service offered by various companies, including RCA and ITT Worldwide Communications, to all members of the public. This Article does not discuss money order wires, such as those provided by Western Union, which raise unique problems.

56. Bank Administration Institute, Studies in Funds Transfer, Operations and Automation Survey Findings (1982) [hereinafter cited as BAI Survey]. One hundred and twenty-seven banks from different regions were surveyed, ranging from money center banks to moderate volume banks to Edge Act subsidiaries. Id. at 3. The lack of contractual coverage is underscored by the fact that only 10% of the respondents indicated that they would refuse to accept a funds transfer not covered by an agreement from an existing customer, and only 24% indicated that they would refuse a transfer from a new customer. Id. at 25.

Second, the rules structuring relationships among bank participants do not address important issues relating to the obligations of other parties. For example, if a bank sender fails to settle and a receiving bank cannot recover back the funds from its customer, does the receiving bank have a legitimate claim for the amount against the corporate originator, the sending bank or both? Does this depend on whether the originator's account has been debited by the sending bank? What defenses might be raised to such causes of action? Typically, the private rules of wire transfer systems leave these questions unanswered.

Third, the system rules inadequately address unauthorized transfers that occur due to fraud or mistake. They are concerned primarily with whether the system will be liable rather than with the equally important issue of apportioning loss among participants when the system is not liable.

Finally, the critical question of whether courts will enforce contractual provisions, particularly those between customers and their banks, remains open. Unlike contracts in the check system, for example, which are broadly legitimized by the U.C.C.,[57] these private contracts do not operate within any statutory framework and may be unenforceable on grounds such as adhesion or unconscionability.[58]

Three factors explain the lack of privately formulated rules between banks and their customers. First, no uniform regime of legal rules and established industry practice exists between banks and their corporate customers. The Bank Administration Institute survey concluded that "[t]he efforts of banks to construct appropriate agreements for funds transfers are seriously hampered by the lack of applicable laws and definition of common banking practice."[59] Second, many customers refuse to accept rules that require them to assume significant risks. Banks are also reluctant to assume these risks and charge higher prices. In a competitive environment, rather than lose customers over this issue, bank account officers are content to have no rules, or minimal rules, and to leave matters to the courts, particularly if their major competitors are following the same strategy. Third, since it is unclear whether private rules would survive in litigation, the effort to procure corporate agreements may not appear worthwhile.

Four other factors explain the dearth of privately formulated rules governing relationships among banks. First, given the relative infrequency with

---

The survey report fails to show how many respondents had agreements in the form of either contracts or corporate resolutions passed by their customers. For domestic transactions, 52% of the respondents had corporate resolutions addressing funds transfer issues and 73% had separate funds transfer agreements, but it is unclear how many respondents had neither. Id. at 55 (Survey Tabulation, Section VI—Funds Transfer Agreements). The percentage of respondents with non-coverage (NC) or unclear coverage (UC) on certain key issues was: time deadlines (48% NC, 4% UC); liability for interest compensation (27% NC, 6% UC); indemnification for consequential damages (25% NC, 8% UC); and indemnification for errors as a result of problems outside the bank's control (19% NC, 8% UC). Id. at 24.

57. U.C.C. §§ 1-103, 4-103.

58. See infra notes 232–34 and accompanying text.

59. BAI Survey, supra note 56, at 25.

which such rules need to be invoked, little operational pressure exists for the development of standard procedures; matters can be handled on an individual basis. In contrast, other payment systems, such as bank credit cards or preauthorized transfers through automated clearing houses, in which the absolute number of events of customer nonpayment, fraud or mistake is much higher, have developed a much more elaborate private contractual structure. Greater efforts to develop private rules characterize the one wire transfer problem that arises frequently—claims for interest compensation for unjust enrichment resulting from mistaken transfers.[60]

Second, in funds transfer systems either not owned by bank users, such as FedWire or telex services, or not owned by all the users, such as CHIPS, the owners may not be able to charge users for formulating rules, particularly when the users have limited influence over the rulemaking process.

Third, even in bank-controlled organizations, the various participants are likely to have quite different ideas about what the rules should be. The organization's management may, therefore, wish to avoid the long and difficult process of arriving at a consensus through the drafting process, particularly when other matters are more pressing. In countries such as Canada and West Germany, which have fewer banks, more unified trade associations, and, perhaps, fewer antitrust restraints on associational activity, reaching a consensus is less of a problem, and interbank agreements more fully structure funds-transfer risks.

Finally, the lack of a clear and uniform set of rules at the bank-customer level makes the task of formulating interbank rules more difficult. The banks only have to apportion risks inter se that are not assumed by customers. Since, as already discussed,[61] such standard bank-customer agreements do not exist, banks find it difficult to formulate comprehensive rules regulating interbank wire transfers.

2. *Common Law.* The common law covering wire transfers is poorly developed. Most of the reported cases are quite old and involve telegraph companies. The remainder address only a limited number of the issues discussed in this Article and covered by the N.P.C.

One set of cases concerns the obligation of the payor bank to its customers on a normal transfer in which no fraudulent or mistaken payment has occurred.[62] The payor bank must act on its customer's instructions, and,

---

60. These efforts have been made through the Council on International Banking and other organizations. S. Preston, Vice President, Chase Manhattan Bank, Remarks on Compensation Related to Errors delivered at the Money Transfer Conference sponsored by the Bank Administration Institute (1982) (cassette tape on file at the offices of the Columbia Law Review). However, the potential future increase in the use of wire transfers cannot be relied on to lead to the formulation of the coherent and comprehensive regime sought to be supplied in the N.P.C..

61. See supra notes 56–59 and accompanying text.

62. Many of these cases involve Western Union or American Express as wire transferors of international money orders where neither the originator nor the beneficiary has an account relationship with the transferor—the originator pays cash for the wire, and the beneficiary is to receive cash, often in a different currency. See, e.g., Haviland v. Western Union Tel. Co., 119 F.

conversely, not act on unauthorized instructions.[63] Yet, when the basic obligation is breached, significant questions remain unsettled: the measure of damages,[64] the responsibility of the payor bank for the misdeeds of its agents,[65] and the nature of the consequent causes of action.

A second set of cases addresses the allocation of losses resulting from payments to the wrong parties. Many involve the unique situation of telegraph transfers claimed by improper beneficiaries—persons falsely claiming to be addressees of a telegram.[66] Since only one transferor—the telegraph com-

---

Supp. 438 (S.D. Tex. 1954); Morris v. Western Union Tel. Co., 24 Ariz. 12, 206 P. 580 (1922); Komatz Constr., Inc. v. Western Union Tel. Co., 290 Minn. 129, 186 N.W.2d 691, cert. denied, 404 U.S. 856 (1971); Culmone v. American Express Co., 3 N.J. Super. 187, 65 A.2d 854 (App. Div. 1949).

63. See Bank of British N. Am. v. Cooper, 137 U.S. 473 (1890); United Milk Prod. Co. v. Michigan Ave. Nat'l Bank, 401 F.2d 14 (7th Cir. 1968); Shrewsbury v. Dupont Nat'l Bank, 10 F.2d 632 (D.C. Cir. 1925); Old Sec. Life Ins. Co. v. Continental Illinois Nat'l Bank, No. 76-C-3623, slip op. (N.D. Ill. July 31, 1980) (available Sept. 8, 1983, on LEXIS, Genfed library, Dist file) ; see also Deport Hardware Co. v. First Nat'l Bank, 232 S.W. 902 (Tex. Civ. App. 1921) (writ dismissed for want of jurisdiction).

64. While generally accepting the *Hadley* rule, see Hadley v. Baxendale, 146 Eng. Rep. 145 (Ex. 1854), cases are divided on the circumstances under which consequential damages can be collected against a transferor, but almost all the reported cases involve telegraph companies. See Morris v. Western Union Tel. Co., 24 Ariz. 12, 206 P. 580 (1922); Siegel v. Western Union Tel. Co., 312 Ill. App. 86, 37 N.E.2d 868 (1941); Taggart v. Western Union Tel. Co., 198 A.D. 366, 190 N.Y.S. 450 (1921); Bostelman v. Western Union Tel. Co., 179 Misc. 121, 37 N.Y.S.2d 662 (N.Y. Sup. Ct. 1942); Baker v. Western Union Tel. Co., 127 S.C. 535, 121 S.E. 593 (1923); McCollum v. Western Union Tel. Co., 180 Tenn. 403, 175 S.W.2d 544 (1943). The telegraph cases decided before 1934 have become largely obsolete due to the limitations on the liability of telegraph companies under the Federal Communications Act. See infra note 159. One recent, celebrated case, Evra Corp. v. Swiss Bank Corp., 673 F.2d 951 (7th Cir.), cert. denied, 103 S. Ct. 377 (1982), concerns the consequential damage liability of an intermediate bank. See infra text accompanying notes 160–62.

A separate group of cases involves the measure of damages when there is a breach of the obligation to pay a beneficiary in a foreign currency where the order has been paid for in dollars. The problem usually arises when war or revolution has interfered with the ability to make such payments. The cases differ as to whether the proper measure of damages is the amount of dollars paid regardless of the extent of interim devaluation of the foreign currency, a rescission measure of damages, see Aachen & Munich Fire Ins. Co. v. Guaranty Trust Co., 27 F.2d 674 (2d Cir.), cert. denied, 278 U.S. 648 (1928); Zion v. Hibernia Bank & Trust Co., 6 La. App. 410 (1927), the value of the foreign currency at the time the payor should have performed, a measure of damages based on the difference between price and market price at the time of the breach, see Avgerinion v. First Guar. Bank, 142 Wash. 73, 252 P. 535 (1927), or no damages at all, on the theory that the foreign currency has no market value in its own country, see Richard v. American Union Bank, 241 N.Y. 163, 149 N.E. 338 (1925).

65. The cases are split as to whether the payor is responsible for the misdeeds of subsequent transmittors of the order. Compare Gravenhorst v. Zimmerman, 236 N.Y. 22, 139 N.E. 766 (1923) (responsible), with Skopetz v. American Express Co., 251 Mass. 136, 146 N.E. 262 (1925) (not responsible).

66. First Nat'l Bank v. Western Union Tel. Co., 25 Ala. App. 108, 142 So. 99, cert. denied, 225 Ala. 38, 142 So. 102 (1932); Davis v. Western Union Tel. Co., 4 Pa. D. & C.2d 264 (Ct. Common Pleas 1954); Western Union Tel. Co. v. Cosby, 99 S.W.2d 662 (Tex. Civ. App. 1936) (writ dismissed for want of jurisdiction); Western Union Tel. Co. v. American State Bank, 277 S.W. 226 (Tex. Civ. App. 1925).

In addition, a limited number of more modern cases involve banks charged with crediting the wrong party. See Tenark Constr. Corp. v. Great Am. Mortgage Investors, 431 F. Supp. 863 (W.D. La. 1977), aff'd without opinion, 566 F.2d 105 (5th Cir. 1978); see also French Bank v. First Nat'l Bank, 585 S.W.2d 431 (Ky. Ct. App. 1979) (double credit to the correct party).

pany—is involved, the cases do not confront the apportionment of risk among multiple banks that may have participated in the same unauthorized transaction.[67] Furthermore, the possible negligence of the payor of the message arises only where that party has failed to require the beneficiary to show some positive identification.[68] The case law is virtually silent on liability where customers negligently allow access to their accounts, where fraud by bank or customer employees or third parties is alleged, or where the messages are altered.

A third set of cases, generally more modern than those described above, covers some payment and settlement problems. Courts occasionally address such issues as when a bank becomes accountable for a transfer through "final payment,"[69] whether a bank must notify its customer when it dishonors an order,[70] and when a beneficiary has the right to withdraw funds represented by an order,[71] but this case law is fragmentary at best.

What explains the poorly developed state of the common law in wire transfers involving multiple banks? Certainly, the problems are not new. Banks have been major users of wire services since the development of FedWire in 1918 and were parties to telegraph transfers, particulary international ones, even before that date. According to bankers, until recently disputes over bank wire transfers were largely resolved by a gentlemen's agreement among the members of the small club of domestic and international bankers involved in these transactions. However, as the number of banks providing wire services increased, and as the amount of money moved by wire grew geometrically in response to technological change, increased trade and interest-rate controls that encouraged corporations to move money out of banks, the gentlemen's agreement approach broke down. The recent increase in reported cases reflects this breakdown.[72]

II. Pay Orders Under the N.P.C.

A strong consensus exists among participants in the various wire transfer systems that a more fully developed legal framework is essential. The N.P.C.

---

67. These kinds of issues are raised, however, by Securities Fund Servs., Inc. v. American Nat'l Bank & Trust Co., 542 F. Supp. 323 (N.D. Ill. 1982), which involved the allocation of loss after a mutual fund had taken a fraudulent redemption order. The custodian bank had transfered funds on the basis of the unauthorized order and a receiving bank had credited an account that matched the account number but not the account name on the wire sent by the custodian.

68. See, e.g., Davis v. Western Union Tel. Co., 4 Pa. D. & C.2d 264 (Ct. Common Pleas 1954); Western Union Tel. Co. v. Cosby, 99 S.W.2d 662 (Tex. Civ. App. 1936) (writ dismissed for want of jurisdiction).

69. See Delbrueck & Co. v. Manufacturers Hanover Trust Co., 609 F.2d 1047 (2d Cir. 1979); Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548 (2d Cir. 1976).

70. Houston Contracting Co. v. Chase Manhattan Bank, 539 F. Supp. 247 (S.D.N.Y. 1982).

71. Cf. Singer v. Yokohama Specie Bank, 293 N.Y. 542, 58 N.E.2d 726 (1944).

72. See United Milk Prods. Co. v. Michigan Ave. Nat'l Bank, 401 F.2d 14 (7th Cir. 1968); Old Sec. Life Ins. Co. v. Continental Illinois Nat'l Bank, No. 76-C-3623, slip op. (N.D. Ill. July 31, 1980) (available Sept. 8, 1983, on LEXIS, Genfed library, Dist file); Nagle v. Lasalle Nat'l Bank, 472 F. Supp. 1185 (N.D. Ill. 1979); Tenark Constr. Corp. v. Great Am. Mortgage Investors, 431 F. Supp. 863 (W.D. La. 1977), aff'd without opinion, 566 F.2d 105 (5th Cir. 1978).

represents the first coherent attempt to regulate the myriad issues that arise in connection with the transfer of funds by wire.

A. *Wire Transfers as Pay Orders*

The N.P.C. applies only to an "order,"[73] a complete and unconditional direction by a person to pay a specific payee.[74] A wire transfer falls within this basic definition. In a typical transaction, Corporation *A*, a "person,"[75] gives a complete and unconditional direction to its bank to debit its account and to effect a credit to the account of Corporation *B* at Corporation *B*'s bank.

The content of the order must also meet certain requisites if the order is to be governed by the N.P.C.[76] It must (1) be of a sum certain of money; (2) be from an account; (3) ask for the transfer to take place immediately, or at a definite time; (4) be for the benefit of an identified payee; and (5) identify the originator—the drawer.[77]

The N.P.C. draws a fundamental distinction between "draw orders,"[78] like checks and credit cards, on which payees or their endorsees receive orders and then collect funds from the banks of the drawers, and "pay orders,"[79] like wires, where payees receive funds through the banking system along with orders, and where there can be no transferees after the payee. On draw orders, the drawer gives the order to the payee directly, as by sending a check in the

---

73. N.P.C. §§ 2, 10. Section 2 provides that the Code "applies to any orders payable by or at, or transmitted by or to, an account institution." Section 10, which defines an "order," provides in relevant part:

> (1) An order is a complete and unconditional direction by a person to pay
> (a) a sum certain in money;
> (b) from an account which may be accessed to pay a person other than the drawer or the drawee;
> (c) to take place immediately or at a definite time;
> (d) to or for the benefit of a specific payee, which may be the drawer, or bearer;
> (e) with no other direction by the drawer except as otherwise provided in this Code; and
> (f) identifying the drawer . . . .
> (2) An order must be more than an authorization or request and must identify the drawee with reasonable certainty.
> drawee with reasonable certainty.

74. An order also includes a payment to oneself, as when a person writes a personal check to herself, or an order to oneself to pay another person, such as a cashier's check.

75. A "person" is an individual or organization. Id. § 50(20).

76. Id. § 10(1)(a)-(f).

77. In the case of a wire transfer, the drawer of an order is the person who initiates the order and whose account is to be debited on the order. Id. § 52(4)(b).

78. N.P.C. § 51(1) defines a "draw order" as

> an order initiated by the drawer and transmitted to the payee, if any, or initiated on behalf of the drawer by the payee and transmitted to an account institution directing the drawee to pay the payee or the bearer or to accept and includes an order to pay to the drawer or the person authorized to draw on its behalf.

A check, in paper form, is a "written draw order." Id. § 51(5), (6).

79. N.P.C. § 51(2) defines a "pay order" as

> an order initiated and transmitted by the drawer to the drawee directing the drawee to pay or effect payment to the payee either directly or through transmitting or settling account institutions, and includes a "wire transfer."

Bill paying by telephone or home terminal, and preauthorized credits through an automated clearing house, are other examples of pay orders. The N.P.C. envisions that a pay order, such as a

mail or generating a credit card sales draft at the point-of-sale. On pay orders, in contrast, the drawer gives the order to its bank, the drawee, which transfers the order through the banking system to the payee. Draw orders *pull* funds back to the payee or its endorsee, while pay orders *push* funds out to the payee.

This distinction is fundamental and its importance can be demonstrated by three illustrations. First, there is a basic difference in the drawee's obligations on a pay order and a draw order. In the case of a pay order, the bank must pay the payee if the payee has an account with the bank, or, if not, the bank must transmit the order on for payment to the payee, such as through the Fed on a FedWire, within some reasonable time.[80] A breach of this obligation results in dishonor of the customer's order.[81] In the case of a draw order, the bank's obligation is to pay on its customer's behalf orders presented to it for collection, usually by another bank. Dishonor of the customer's order results from a refusal to pay a properly payable order.[82]

Second, the obligations of parties other than the drawee are different for pay and draw orders. On a pay order, a subsequent bank receiving an order *and* payment from the drawee has the obligation to pay the payee, if the payee has an account with the bank, or to transmit the order and payment on to another bank for payment.[83] In the case of a draw order, however, parties who negotiate orders, including the payee, are called upon to make good on the order to any party who winds up holding an unpaid order. This is the standard contract of the endorser.[84]

Third, the rules allocating losses on unauthorized draw orders often should differ from those allocating losses on unauthorized pay orders. For example, if the risk of a fraudulently drawn check should be allocated to the party dealing with the forger, a drawee should not be responsible for paying a check with a forged drawer's signature.[85] In the case of a pay order, the drawee accepting an order not authorized by the drawer would still be left with the loss; it is the party dealing with the wrongdoer.[86]

B. *Contracts to Pay on Authorized Orders*

1. *Contracts of the Drawer and the Drawee.* We must start with two of the basic contracts on a pay order—those of the drawer and the drawee. The drawer of a pay order is the customer that orders its bank—the payor account institution[87] or drawee[88] in N.P.C. terminology—to pay a specified payee. In

---

bill-paying order, can be implemented by a draw order, such as a cashier's check from the bill payor's bank to the payee. Id. § 10(4).

80. See Id. § 101(1); infra note 96 and accompanying text.

81. N.P.C. § 415(2)(c); see also infra note 97.

82. See U.C.C. §§ 4-401(1), 4-402, 3-507.

83. N.P.C. § 102(2).

84. U.C.C. § 3-414(1).

85. The N.P.C. would adopt such a rule for checks. N.P.C. § 204(1). However, the U.C.C. currently allocates the risk to the drawee. U.C.C. §§ 3-401, 4-401(1), 4-207(1).

86. See N.P.C. § 101.

87. N.P.C. § 53(1) defines an "account institution" as "any person which in the ordinary course of its business maintains accounts for its customers." An "account," id. § 50(1), is a

short, the drawer is the person that initiates the order.[89] The N.P.C. provides that the drawer of an authorized order—an order that is authorized by the drawer and that has not been materially altered[90]—"agrees with the funds claimant that upon dishonor of . . . a pay order by the drawee or any subsequent transmitting account institution, and any necessary notice of protest or dishonor," it "will pay the amount of the authorized order to the funds claimant."[91] The "funds claimant" on a pay order is the party that has not been paid.[92] A "funds claimant" may be either the specified payee or a "funds transferor," a person that has given value on the order.[93] A funds claimant must have "notice of the order prior to any revocation of the order by the drawer,"[94] since it is only with notice that the funds claimant may properly rely on an expectation of payment.

"liability in money, credit extended or interest in assets on which orders may be drawn or to which orders may be credited." A "payor account institution," id. § 53(4), is the "account institution which maintains the account directed to be debited by the drawer of an order." The N.P.C. uses the term "account institution" rather than "bank" because there are depository institutions other than banks and because even nondepository institutions, such as department stores, finance companies or mutual funds, may hold accounts.

88. A drawee "is a person who is directed by an order to make payment, including a payor account institution." Id. § 52(5). A drawee, therefore, may or may not be an account institution.

89. See supra note 77.

90. Certain N.P.C. provisions apply only to authorized orders, which are defined, in essence, to include those orders in which there is no diversion of funds, by fraud, mistake or otherwise, to a wrong party or in the wrong amount. N.P.C. § 54(1) defines "authorized order" as an order that:

> is initiated by the drawer or with the drawer's consent or authorization or is authorized to be paid by the drawer and remains so unless it: (a) is materially altered; or (b) is transmitted without any necessary authorization. . . .

"Material alteration" is, in turn, defined in N.P.C. § 54(3) as follows:

> Any alteration of an order is material which by encoding or otherwise
> (a) changes the amount of the order; or
> (b) changes the number, relation or identity of the parties; or
> (c) changes the account number of any party; or
> (d) changes the identity of any account institution specified in the order; or
> (e) completes an incomplete order otherwise than as authorized; or
> (f) changes a specified date on which value is to be given for or on the order.

When an order is authorized, the basic risks with which the N.P.C. is concerned are (1) failure to make payment, due to the insolvency or insufficient credit of a participant, or (2) the failure to make a timely payment.

91. Id. § 100.

92. N.P.C. § 52(11) defines "funds claimant" on a pay order as follows:

> A funds claimant is any person who meets the following conditions:
> (a) the person becomes a payee . . . or funds transferor on the order at a time when the order is authorized;
> (b) the person has not, unless otherwise agreed, received money or a credit to an account withdrawable as of right, or has reimbursed such a party, at the time the person seeks to enforce its rights;
> . . . .
> (d) in the case of a pay order, the specified payee or funds transferor has notice of the order prior to any revocation of the order by the drawer.

The N.P.C. discards the concept of "holder" because the right to enforce an electronic order cannot be tied to possession; indeed, in the case of pay orders, payees have no contact at all with the order. Cf. U.C.C. §§ 1-201(20), 3-202(1).

93. N.P.C. § 52(10) defines a "funds transferor" as "any person other than the drawer or payee who is directed to pay or effect payment on a pay order to the payee and gives money or a credit to an account withdrawable as of right on such pay order."

94. Id. § 52(11)(d).

The payor account institution has its own contract with the drawer. The N.P.C. provides that the payor account institution "agrees with its customer that it will not . . . pay or transmit for payment an unauthorized pay order."[95] The payor account institution also agrees that it will "pay or effect payment to the payee's account institution on an authorized pay order."[96] A payor account institution is liable for all actual damages proximately caused to the customer by the wrongful dishonor[97] of an authorized order. However, on corporate wire transfers damages may only include consequential damages when "the dishonor results from an intentional act of the payor account institution, including an unlawful setoff or hold placed on an account, but unless otherwise agreed the good faith failure to transmit a pay order is not itself an intentional act."[98] A payor account institution can also be liable to its customer "for the amount of any debit wrongfully made to the customer's account."[99] A key feature of the payor account institution's contract with the drawer is that the payor account institution must either pay or "effect payment to"[100] the payee's account institution. That is to say, its obligation goes beyond merely transmitting an order to the payee's account institution or to an intermediate transferor. If the order does not get to the payee's account institution, whether due to the fault of the payor account institution or the subsequent transferor, the payor account institution fails to meet its basic obligation, and is accordingly responsible.[101]

a. *The Two-Bank Transfer*. The application of the N.P.C.'s contractual obligations of the drawer and drawee is best understood by working through several examples. Suppose Corporation *A* orders its bank, Bank One, to transfer $1 million to the account of Corporation *B* at Bank Two. Bank One sends a CashWire to Bank Two for the account of Corporation *B*, and Bank Two gives Corporation *B* notice of a credit for immediate withdrawal, but ultimately conditional upon CashWire settlement occurring by the beginning of the next day. Bank One fails to settle and other CashWire participants fail to cover Bank One's position, so that the N.Y. Fed refuses to settle positions and the participants are left to their own devices.[102] At this point, Bank Two

95. Id. § 101(1).

96. Id.

97. Dishonor of a pay order occurs when, following presentment, "the payor account institution, not holding the account of the payee, fails to transmit the order or make payment to another account institution, for payment to the payee, on the business day it is received." Id. § 415(2)(c). The words "or make payment" were added to Permanent Editorial Board Draft No. 3 in the version of the Draft presented to the Commissioners on July 26, 1983. Presentment by the drawer to the payor account institution is "a demand that payment be made or effected to the payee." Id. § 413(1).

98. Id. § 101(2)(d).

99. Id. § 101(4).

100. Id. § 101(1).

101. Id. § 101(1) & comment 1. Section 101 also provides that the payor satisfies its obligations once funds are received by the payee's account institution. This result is consistent with the few relevant cases. See Burke v. National Shawmut Bank, 284 Mass. 36, 187 N.E. 114 (1933); Silverman v. National City Bank, 133 Misc. 201, 232 N.Y.S. 339 (Sup. Ct. 1928).

102. See supra notes 29–36 and accompanying text.

may not be able to recover the payment made to Corporation *B*. CashWire's settlement rules make no provision for the ultimate liability of participants.

If Bank Two does not recover payment, it is a "funds claimant";[103] it is a "funds transferor"[104] that has given value on the order to Corporation *B* and has not received funds from Bank One. As a funds claimant, Bank Two has an action on the order against Corporation *A*, because Corporation *A* has agreed that upon dishonor of the order by Bank One it will pay the funds claimant. Dishonor of the order by Bank One occurred as a result of its failure to pay Bank Two. If Bank Two had recovered funds from Corporation *B*, then Corporation *B* would be the funds claimant since it would be a payee with notice of an order that had not been paid and would thus be able to sue the drawer on the order. The Article later discusses whether Bank One is also liable to a funds claimant in this situation.[105]

If, pursuant to its drawer's contract,[106] Corporation *A* has to pay the funds claimant, Corporation *B*, on the order, and has also had its account debited by Bank One for the amount of the order, it is out $1 million. Corporation *A* can recover this amount as a wrongful debit from Bank One, which obviously is not entitled to the $1 million. If, on the other hand, Bank One has not debited Corporation *A*'s account for the order, no wrongful debit exists and *A* has no claim against the bank. Indeed, the latter case may arise more frequently because the drawer's overdraft may have caused Bank One not to pay Bank Two. Corporation *A* would be left in the correct position; its account would not have been debited, and would only be out the $1 million that it owed on the order to Corporation *B*.

One could argue that once the drawer's account has been debited, the drawer should be discharged and the funds claimant should proceed against Bank One, the payor account institution. Under this view, a wire is like a cashier's check, which only carries the issuing bank's credit, since the bank is both the drawer and drawee. However, the payee on a cashier's check can refuse to "take" a payment on which the bank's credit is the only credit on which it may rely by rejecting the check as adequate payment.[107] This choice might be exercised if the payee believed the issuing bank was about to become insolvent. The payee never "takes" a wire transfer, and should not, therefore, be forced to accept the bank's credit in substitution of the obligor's credit.

Apart from Corporation *A*'s action against Bank One for wrongful debit, *A* may also have an action for wrongful dishonor that would allow *A* to recover all actual damages proximately caused by Bank One's dishonor of the order.[108] For example, *A* may have lost a valuable contract right as a result of

---

103. N.P.C. § 52(11).
104. Id. § 52(10).
105. See infra notes 138–47 and accompanying text.
106. See supra note 91 and accompanying text.
107. Compare U.C.C. § 3-802(1)(a) with N.P.C. § 801(1)(a) (treating the discharging effect instruments and orders differently depending on the availability of recourse against the underlying obligor).
108. The damage liability of account institutions other than the payor is discussed infra at Section II D.

Bank One's failure to pay Corporation *B* by an agreed date. The N.P.C. allows such damages only when a wrongful intentional act by Bank One causes the dishonor.[109] For example, if the dishonor resulted from a wrongful setoff or hold placed on the account in response to an attachment order, a full measure of damages is available. When banks place holds on accounts or exercise setoffs, it is reasonable to expect that officers are aware of the damage consequences of dishonor. However, if the dishonor results solely from "a good faith failure to transmit"[110] the order due to processing errors, no consequential damages are available under the N.P.C. This limitation on consequential damages protects account institutions[111] against unforeseeable damages resulting from processing mistakes, such as errors by bookkeepers or computer operators.[112]

Under the N.P.C., our analysis would not change if Bank One had debited the drawer's account and become insolvent before the drawer could recover its money through a wrongful debit action.[113] Appropriately, the drawer would be at risk for the insolvency of its own bank. If recovery were denied to a funds claimant under these circumstances, the funds claimant would be at risk for the insolvency of a bank with which it has not chosen to deal.

The example given can be generalized to other cases in which Bank One fails to pay Bank Two; such as a settlement failure in CHIPS[114] or any other settlement failure in CashWire,[115] or where there is no settlement through correspondent accounts on transfers through BankWire II, S.W.I.F.T.[116] or telex. A failure to pay Bank Two could not arise, however, if Bank One had sent a FedWire to Bank Two, because Regulation J assures that credit extended to Bank Two by the Fed is not conditioned upon Bank One's covering its position with the Fed.[117] In this case, the Fed becomes a funds claimant.

Without these N.P.C. provisions, neither the payee nor Bank Two, depending on which is the funds claimant, would have a clear right to sue Corporation *A on the order*. While the payee could sue Corporation *A* on the

---

109. N.P.C. § 101(2). Of course, this situation leaves open a claim for negligently caused loss of interest on an interest bearing account during the period of a wrongful debit. See infra notes 169–72 and accompanying text.

110. "'Good faith' is the absence of bad faith. Bad faith is 'dishonesty in fact, malice in the conduct or transaction concerned, or willful or reckless disregard of known material facts.'" N.P.C. § 50(3).

111. N.P.C. § 101(2)(d).

112. "The effect of this provision is to restrict consequential damages on corporate wire transfers since the drawer, who knows the importance of timeliness, can allow for sufficient time to take corrective action if the wire misfires, or insure." N.P.C. § 101 comment 2.

113. If the payor account institution has not yet transmitted the order or advised a subsequent bank or payee that the order will be transmitted—has not finally paid the order, see N.P.C. § 420(2); infra text at note 138—the order should be considered cancelled and returned to the drawer since there can be no justified reliance on the order. See N.P.C. § 429(1).

114. See supra notes 37–49 and accompanying text.

115. See supra notes 28–36 and accompanying text.

116. See supra notes 50–54 and accompanying text.

117. See supra text at note 27.

underlying obligation, this claim does not help Bank Two. Corporation *A* owes no such obligation to Bank Two. The N.P.C. provides for drawer liability because the drawer has in effect admitted the validity of the underlying obligation by making the payment. If Bank Two cannot recover its payment to Corporation *B*, it should benefit by this admission just as much as would the obligee, Corporation *B*, had it not received the funds. The same rationale supports making a drawer liable on a check apart from its liability on the underlying obligation. Under the N.P.C., a suit on the order is more advantageous to *A*. In addition to certain procedural advantages that funds claimants enjoy under state law,[118] and the presumption that the order is authorized—that is, that it has not been materially altered[119]—funds claimants with "due-course rights" are not subject to defenses the drawer might be able to raise to a suit on the underlying obligation.[120]

To have due-course rights under the N.P.C., a funds claimant must have given value.[121] By definition, all funds transferors give value on the order. A payee that has supplied goods and serivces to the drawer also "has given value for an order."[122] A funds claimant with due-course rights must also have

---

118. Some states give procedural advantages to actions based on payment orders. For example, under the New York CPLR, in an action "based upon an instrument for the payment of money," a motion for summary judgment may be served with the summons, and the complaint stage can be dispensed with. N.Y. Civ. Prac. Law § 3213 (McKinney 1970). While a check clearly qualifies as an "instrument," U.C.C. § 3-104, it is unclear whether the procedure could be used in the case of a wire transfer.

119. N.P.C. § 508(1) provides that the accuracy of a copy of an electronic order made contemporaneously with the receipt or transmittal of an order is admitted unless specifically denied in the pleadings.

N.P.C. § 508(3) provides that the funds claimant has the burden of establishing the contents of an electronic order when the order's accuracy is put in issue. It also provides that a "copy of an order made and retained by a transmittor contemporaneously with the receipt or transmittal of the order is presumed to reflect accurately the contents of the order." A transmittor is "any person which transmits or processes an order." Id. § 53(5). A copy includes a tape or computer printout journal. This presumption is stronger than the presumption of the genuineness of a signature on a written draw order like a check, provided in N.P.C. § 508(1), following U.C.C. § 3-307(1), because the entire content of the record is given presumptive validity. On a check, the signature presumption "rests upon the fact that in ordinary experience forged or unauthorized signatures are very uncommon, and normally any evidence is within the control of the defendant or more accessible to him." U.C.C. § 3-307 comment 1. This rationale would hold for all information on a contemporaneous copy; such a copy is difficult to alter and will usually be reliable.

120. N.P.C. § 104(1) provides that a "payee . . . who has given value for an order, or a funds transferor, acquires due-course rights if it . . . receives or has notice of an authorized pay order (a) in good faith; and (b) without notice that the order is stale or has been dishonored or of any defense against or claim to it on the part of any person." Both the payee and the funds transferor can be funds claimants.

N.P.C. § 104(4) provides that

> to the extent that a funds claimant has due-course rights on an authorized order, it receives the order free from (a) all claims to the order on the part of any person; and (b) all defenses and counterclaims, including setoff, of any person with which it has not dealt except [certain "real defenses"].

This language follows U.C.C. § 3-305.

121. N.P.C. § 104(1).

122. Id.

received or had notice of the order in good faith and "without notice that the order is stale or has been dishonored or of any defense against or claim to it on the part of any person."[123] If, for example, either Bank Two or Corporation *B* actually knew when it received the order that Bank One would or could not pay, the good faith or notice requirements would not be satisfied. In addition, defenses on the underlying obligation are only cut off as between parties that have not dealt with each other.[124] While this limitation presents no obstacle to Bank Two, Corporation *B* might have dealt with Corporation *A* on the underlying obligation. By contrast, if Corporation *B* had received the $1 million from Corporation *A* in settlement of a sale of securities through a broker, Corporation *B* would not have dealt with Corporation *A*. *B* could use its "due-course rights" status to cut off any of *A*'s defenses against the broker, such as a failure to deliver the securities.

b. *The Three-Bank Transfer.* Additional considerations come into play when a third bank participates in the transaction. Suppose Corporation *A* orders its bank, Bank One, to transfer $1 million to the account of Corporation *B* at Bank Two. Bank One debits *A*'s account and transmits a telex message to Middle Bank, at which Bank One has an account, requesting it to make a transfer to Corporation *B* at Bank Two. Middle Bank, in turn, debits Bank One's account and sends a telex to Bank Two requesting it to transfer funds to Corporation *B*, and promising to pay by FedWire before the end of the day. Bank Two gives Corporation *B* notice of a credit, available for immediate withdrawal, but ultimately conditional upon receipt of Middle Bank's FedWire. Middle Bank does not settle as promised. We will now examine the circumstances in which the N.P.C. allows the funds claimant, either Corporation *B* or Bank Two, to sue on the drawer's contract.[125]

Assuming Corporation *B* is the funds claimant,[126] if Corporation *B* is permitted to recover the $1 million from Corporation *A*, Corporation *A* has lost an extra $1 million due to the previous debit against its account by Bank One. Unlike the two-bank transfer in which Bank One failed to pay Bank Two, thus dishonoring the order, in the three-bank transaction, Bank One has properly honored the order and paid Middle Bank by means of the debit Middle Bank made to Bank One's account.

There are two reasonable solutions to the problem of making *B* whole and ultimately placing the loss with Middle Bank where it belongs. First, *B* may be denied recovery against *A* but allowed to sue Middle Bank directly. Second, *B* may be allowed to pursue *A*, the drawer, forcing *A* to pursue its remedies either against Bank One, which can then pursue Middle Bank, or against Middle Bank directly by subrogation to Bank One's rights. The

---

123. Id. § 104(1).

124. Id. § 104(4).

125. See infra notes 138–47 and accompanying text (discussing the question of Middle Bank's liability to the funds claimant).

126. This analysis would be equally applicable if Bank Two were assumed to be the funds claimant.

N.P.C. allows *B* the choice of either pursuing Middle Bank in a single action,[127] or pursuing *A*,[128] leaving *A* to bear the risks and transaction costs of pursuing either Bank One or Middle Bank.

The first solution, *B*'s exclusive remedy against Middle Bank, may be more efficient than *B*'s suit against *A*, since it requires the dispute to be resolved through a single action rather than through a chain of up to three actions. However, this solution forces *B* to pursue a remedy against a party with which it has not chosen to deal; Bank One chose Middle Bank as a correspondent. Bank One should be responsible for the defaults of its agents and *A*, in turn, should be responsible for the choice of Middle Bank by its agent, Bank One.[129] From *B*'s perspective, *A* still owes it money and it should be *A*'s problem that its bank selected an unreliable intermediary. The matter is further complicated by taking account of the possible insolvency of Middle Bank. If *B* could pursue only Middle Bank, *B* would bear the risk of Middle Bank's insolvency. *B* would be powerless to avoid this risk imposed without its consent or knowledge since the selection of Middle Bank was made by others.

Thus, while *B*'s suit against Middle Bank often may be the most desirable course to take, it is unfair to impose on *B* the *requirement* of pursuing a party with which it has not chosen to deal, and of bearing the risk of that party's insolvency. The N.P.C. avoids this result by allowing the funds claimant the option of recovering against the drawer, even though that choice could result in as many as three causes of action. Since, under the N.P.C., *A* can recover from Bank One,[130] and since Bank One may recover from Middle Bank,[131] it is proper that *A* and, in turn, Bank One, should be forced to seek their remedies

---

127. See infra notes 138–47 and accompanying text.

128. N.P.C. § 100 allows *B* to sue *A* on *A*'s drawer's contract.

129. This is the majority rule under common law. See Gravenhorst v. Zimmerman, 236 N.Y. 22, 33, 139 N.E. 766, 770 (1923) ("[T]he contract made between these parties was one upon the part of the banker in consideration of a large amount of money received by him to establish a given credit by wireless message confirmed by letter. This agreement by necessary implication made the instrumentalities of wireless and mail his agents and his responsibility extended far beyond a mere delivery of a wireless message or letter."); see also Shrewsbury v. Dupont Nat'l Bank, 10 F.2d 632, 634 (D.C. Cir. 1925) (holding that a bank undertaking to forward credit assumed responsibility for failure of its agent to carry out instructions). But see Skopetz v. American Express Co., 251 Mass. 136, 146 N.E. 262 (1925) (holding that the drawer must sue the bank which failed to perform, and has no action against its own bank).

The split in wire transfer case law parallels the division among courts in check cases before the adoption of the U.C.C. Under the "New York rule," a depository bank was responsible for the negligent acts of its agents, while under the "Massachusetts rule" the depositor had to pursue the negligent agent and had no action against its own bank. See Scott, supra note 10, at 762–64. The U.C.C. adopted the "Massachusetts rule." U.C.C. § 4-202(3) comment 4. In check cases, however, the issue is the failure of a bank to collect payment, rather than the failure to pay. This distinction is important because a bank that negligently handles a check is not likely to be insolvent, while a bank that fails to settle on a wire transfer is more likely to be. N.P.C. § 411 adopts the "Massachusetts rule" for failures to transmit any order, but N.P.C. § 101(1) adopts the "New York rule" for failures of payment on pay orders by making the payor account institution responsible for effecting payment to the payee's account institution. N.P.C. § 411 comment b.

130. N.P.C. § 101(1).

131. Id. § 102(2).

from the party which they have effectively made their agent and with which they have chosen to deal.

It may be argued that allowing recovery against *A* puts *A* at risk for the insolvency of either Bank One or Middle Bank. Upon further inspection, it becomes clear, however, that *A* shoulders only the risk of Middle Bank's insolvency. If *A* cannot recover from Bank One due to Bank One's insolvency, the N.P.C. gives *A* the option of suing Middle Bank directly as Bank One's subrogee.[132] Thus, *A* only bears the risk of Middle Bank's insolvency if its own bank, Bank One, is insolvent. *A* freely assumed this risk and could have avoided it by dealing with a more financially sound bank. If Bank One is not insolvent, Bank One bears the risk of Middle Bank's insolvency, again, a risk it assumed and could have avoided.

A drawer's obligations to ensure payment on a pay order only come into play in the relatively rare case of the failure of an account institution to pay a properly authorized order. Nonetheless, rare cases do occur, and transactors should know in advance the risks they incur. The N.P.C. clarifies to the drawer and other parties the legal consequences of the failure of account institutions to pay and appropriately allocates both the risk of loss or insolvency and the transaction costs of recovery.

2. *The Funds Transferee's Contract.* A "funds transferee" on a pay order is any person, other than the drawer, payee or drawee, that receives "money or a credit withdrawable as of right."[133] The N.P.C. bases a funds transferee's obligation on a simple principle that should not be controversial: an intermediate party between the drawer and the payee that gets paid should make payment. The N.P.C. provides that, in the case of an authorized pay order, a funds transferee agrees that it will "pay or effect payment to the payee or the payee's account institution in accordance with the terms of the order."[134]

Returning to our two-bank example, suppose that Bank Two, the funds transferee, does not post a credit to Corporation *B*'s account, even after payment by Bank One. Under the N.P.C., Corporation *B*, the funds claimant, could recover the amount of the order from the funds transferee, Bank Two, a perfectly obvious result that unfortunately is not assured by existing law. In the three-bank example, Middle Bank is a "funds transferee"; it has received money by debiting Bank One's account. It breaches its fund transferee's contract when it fails to credit Bank Two. Bank Two or Corporation *B* (or, if *B* has recovered against *A* on *A*'s drawer's contract, Corporation *A*), depending on which of these parties is out of pocket, can sue Middle Bank for breach of contract.

---

132. This result obtains under N.P.C. § 102(2), which provides that a funds transferee, such as Middle Bank, that has received funds from Bank One, see id. § 52(9), "agrees with its immediate funds transferor [Bank One] or any party subrogated to the rights of such funds transferor [Corporation *A* or *B*] that it will pay or effect payment to the payee or the payee's account institution in accordance with the terms of the order."

133. Id. § 52(9).

134. Id. § 102(2).

3. *Discharge of Contracts.* If a drawer or funds transferee pays the funds claimant on an authorized order, the N.P.C. provides that their contractual obligations are discharged.[135] Similarly, if the payor account institution pays the funds claimant, the drawer's obligation on the order is discharged.[136] In both cases, discharge should occur to prevent double recovery by the funds claimant. Furthermore, once the drawer has been discharged on the order, it is also discharged on the underlying obligation.[137]

C. *Finality, Availability and Chargeback*

The N.P.C. specifies when payment on a pay order by an account institution is final and the consequences of finality. It also specifies when the beneficiary of a pay order, the payee, has the legal right to withdraw funds on the order from its account institution. In addition, it outlines circumstances under which an account institution failing to get paid on an order can pursue remedies against its customer to recover a posted credit.

1. *Final Payment.* The N.P.C. provides that a payor account institution or transmitting account institution normally is deemed to have finally paid a pay order when it has taken any one of three actions: (1) transmitted the pay order; (2) given an advice to the payee that the order will be transmitted; or (3) given an advice to the payee's account institution that the order will be transmitted.[138] If the payor account institution or transmitting account institu-

---

135. N.P.C. § 153(1), which follows U.C.C. § 3-603, provides that the "liability of the drawer . . . or any funds transferee on an authorized order, is discharged to the extent of any payment or satisfaction rendered by or on behalf of such party to a funds claimant."

136. N.P.C. § 151(2) provides that an "authorized order once transmitted remains in existence until: (a) there are no funds claimants on the order." This statement assumes that the payor account institution has no further cause of action as a funds claimant on the order. In our three-bank example, however, where the payor account institution reimburses the drawer, after the drawer has paid the funds claimant, the payor still has a cause of action as a funds claimant against Middle Bank since a funds claimant includes a person who "has not, unless otherwise agreed, received money or a credit to an account withdrawable as of right, *or has reimbursed such a party*." Id. § 52(11)(b) (emphasis added).

137. N.P.C. § 801(1)(b), which is analogous to U.C.C. § 3-802, provides that "discharge of the underlying obligor on the order also discharges the obligor on the obligation."

138. N.P.C. § 420(2) provides:

> A pay order is finally paid by a payor account institution or transmitting account institution when it has done any of the following, whichever happens first:
>
> (a) transmitted an order, or given advice that the order will be transmitted to the payee or to the account institution receiving payment on its behalf, without the reservation of a right to revoke the order communicated to or known by the payee or the account institution receiving payment on its behalf; or
>
> (b) transmitted an order, or given advice that the order will be transmitted to the payee or to the account institution receiving payment on its behalf without revoking the order by the end of the business day on which the order was transmitted or the advice given; or
>
> (c) agreed to be liable for the order under statute, regulation, clearing house rule or agreement.

The concept of final payment on pay orders is supported by the business practice under which parties receiving wires expect the sender to pay them and regard the sender's bank as supplying with the transfer an executory promise to transfer funds in settlement. Its technical legal foundation is in the law of assignment. The drawer can be viewed as asking its agent bank to assign the funds in its account to the beneficiary of the payment. Once the assignment is made by transmit-

tion has finally paid, it is liable to the funds claimant for the amount of the order.[139] However, even if one of the three events described above has taken place, final payment has not occurred either if the payor account institution explicitly reserved the right to revoke the order, or if such reservation, though not explicit, is known by the payee or the receiving account institution.[140] If the order is conditional, the N.P.C. deems payment final automatically if the order is not revoked "by the end of the business day on which the order was transmitted or advice given."[141] In addition, final payment can occur if a payor account institution or transmitting account institution has "agreed to be liable for the order under statute, regulation, clearing house rule or agreement."[142] Such a statute, regulation or rule overrides the otherwise applicable N.P.C. provisions.

The $1 million, two-bank CashWire example above, in which Bank One has not paid and other participants have not covered Bank One's position can be used to explore the application of these provisions. One of the three normal conditions for finality has been met: Bank One has transmitted the order. Absent the reservation of a right to revoke, Bank Two and the payee may legitimately rely on payment by Bank One. If Bank One had never acted on the order by transmitting it, no claim on the order could be made against it.

The example assumes that Bank One has not reserved the right to revoke the order and that payment is not independently required by "statute, regulation, clearing house rule or agreement." In reality, CashWire rules provide that Bank One must pay on all orders sent through the system.[143] The rules of FedWire and CHIPS are similar;[144] an order is final when entered into the system. Thus, only if Bank One reserved the right in a communication over some other system, such as telex, would final payment fail to occur. In practice, however, regardless of the system used, if such a reservation were made, it is unlikely that Bank Two would post a credit to Corporation *B*'s account.

Given final payment, the funds claimant can recover the amount of the order from Bank One; the latter's credit is now on the order. Thus, Bank Two, if it gave and could not revoke Corporation *B*'s credit—or Corporation *B*, if it received a credit subsequently revoked by Bank Two—could recover the $1 million from Bank One. This right of a funds claimant must be viewed in tandem with its right to sue the drawer, Corporation *A*, discussed previously.[145] When final payment occurs in our two-bank example, the funds claimant can recover the amount of the order from either the drawer or payor

---

ting the order or when the assignee has notice, by advice, the assignment is complete. See Delbrueck & Co. v. Manufacturers Hanover Trust Co., 609 F.2d 1047, 1051 (2d Cir. 1979).

139. N.P.C. § 420(3).

140. Id. § 420(2)(a).

141. Id. § 420(2)(b).

142. Id. § 420(2)(c).

143. Fed-BankWire Agreement, supra note 29, para. 9.

144. 12 C.F.R. § 210.36(a) (1983); CHIPS Rules, supra note 41, para. 7.

145. See supra notes 87-101 and accompanying text.

account institution. If a wire has not been finally paid, as when it is transmitted on a conditional basis, it carries only the drawer's credit.[146]

In the three-bank example, the N.P.C. effectively substitutes the credit of Middle Bank for that of the payor account institution, Bank One. When Middle Bank has been finally paid, as defined above, by the payor account institution, Bank One is discharged. Middle Bank becomes a funds transferee and must transmit the order on through the system to the payee's account institution. This obligation constitutes the funds transferee's basic contract. If Middle Bank does transmit the order, it incurs a final-payment obligation identical to that of Bank One in the two-bank example.

If the payor gives a conditional credit to Middle Bank—that is, the payor does not finally pay—the N.P.C. imposes no obligation on Middle Bank to act on the order, because a further transfer exposes Middle Bank to a final-payment obligation.[147] If Middle Bank does act in such a situation, it would probably make its transfer conditional so as to minimize its potential obligation. Thus, if Bank One's telex stated that payment to Middle Bank was conditional on settlement by the drawer by the end of the day, Middle Bank's transfer to Bank Two would be made conditional upon Middle Bank's receiving value from Bank One.

2. *Availability and Chargeback.* The N.P.C. has two related provisions which specify circumstances in which a customer has the right to withdraw funds from its account institution. First, the N.P.C. provides that where an account institution becomes a funds transferee on a pay order for its customer on a given business day, the customer has the right to withdraw the funds represented by the order at the opening of the account institution's next business day.[148] A "business day" is any day the account institution is open to the public for conducting substantially all its functions.[149] An account institu-

146. A similar situation can, of course, arise in the case of a draw order such as a check. If a payor bank does not actually settle for a check, the check is dishonored, triggering the contract of the drawer. U.C.C. §§ 3-413(2), 3-507(1). If the payor bank has not returned the check by its midnight deadline, it has "finally paid" the check and is liable for the amount of the order. U.C.C. § 4-213(1). Thus, a payee or depository account institution to whom the check is later returned unpaid could sue either the drawer or the payor bank for the amount of the order.

147. See N.P.C. § 411(6) (providing that "[n]o transmitting account institution is required to transmit a pay order before it has become a funds transferee on such order"); id. § 102(2), (requiring the funds transferee to "pay or effect payment to the . . . payee's account institution in accordance with the terms of the order").

148. N.P.C. § 421(1) provides that: "[u]nless otherwise agreed, an account institution is liable to its customer for the actual amount of . . . (b) a pay order received for its customer at the time the customer has the right . . . to withdraw credit given on the order." N.P.C. § 421(2)(c) provides, in turn, that credit given by an account institution is available for withdrawal as of right "where the account institution becomes a funds transferee on a pay order for its customer, at the opening of the account institution's next business day following the business day on which it becomes a funds transferee." For example, if an order is value dated, "give value on December 5," and the receiving bank gets paid on the order on December 1, an account institution could agree with its customer, pursuant to the "unless otherwise agreed" language in N.P.C. § 421(1), to delay availability until the value date. Absent such agreement, N.P.C. § 421(2)(c) requires the account institution to make credit available for withdrawal by the next business day following December 1.

149. Id. § 50(2).

tion, however, can establish a cut-off hour for measuring a business day as early as 2:00 p.m., so that an order received after 2:00 p.m. on Business Day One is deemed to have been received on Business Day Two and is not withdrawable as of right until Business Day Three.[150] The N.P.C. may be unnecessarily liberal in this regard, since banks receive communications over FedWire, BankWire, and other systems until long after 2:00 p.m. and orders can easily be posted to accounts overnight.

The customer's right to withdraw depends on the account institution's having become a funds transferee. In our two-bank example, if Bank One has not actually paid the order, and other participants have not covered its position, Bank Two is not a funds transferee and Corporation *B* has no right to withdraw the $1 million from Bank Two. Sensibly, the customer's right to demand "good funds" should be conditioned upon actual payment to its account institution. Moreover, an account institution which has itself received "good funds" should be required to allow its customer to withdraw the funds within a reasonable period of time. Quite apart from possible concern over the distribution of float, a minor consideration in a corporate transaction, account institutions often do not contract with their customers about the timing of availability and disputes may arise. By setting forth these provisions, the N.P.C. fills a potentially troublesome gap in the private contractual arrangements governing wire transfers.

Second, the N.P.C. provides that an account institution can either charge back, revoke a credit or seek a refund for money that has been withdrawn when the account institution has not actually received payment and has promptly notified its customer after learning that the order is unpaid. Such notice must normally be given by midnight of the business day following the business day on which the account institution learns of the nonpayment, but may be made "within a longer reasonable time after it learns that final payment has not been received or has been undone."[151] Again, the policy is easily understood. Where an account institution has posted a credit to a customer but has not been paid,[152] the account institution should be able to revoke the credit or recover any funds that have been withdrawn, subject only to its obligation to furnish prompt notice to its customer.

This principle should apply regardless of whether funds have actually been withdrawn, since the customer is able to take protective action, such as suing the drawer or payor account institution for the amount of the order. In our two-bank example, Bank Two has the right to charge back or revoke a credit or seek a refund from Corporation *B* if Bank One does not pay. If Bank Two is successful, it is made whole and Corporation *B* becomes the funds claimant. If it is not successful—Corporation *B* may be insolvent or may

150. Id. § 400.

151. Id. § 424(1).

152. Recipients of CHIPS payments are commonly advised by their banks that "good funds" are conditional upon CHIPS settlement. Telephone interview with Seymour R. Rosen, Vice President, Citibank (February 4, 1983).

otherwise refuse to return the money—then Bank Two is the funds claimant and may invoke the obligation either of *A*, the drawer, or, if final payment has occurred, of Bank One, the payor account institution.

Under the N.P.C., as well as the U.C.C.,[153] Bank Two need not exhaust its remedies against its own customer (Corporation *B*) in order to claim on the obligations of Corporation *A* or Bank One. It is free to invoke these obligations immediately even if it could easily have charged back or revoked a credit. This option is a matter of some consequence.

If Bank Two charges back and Corporation *B* becomes the funds claimant, any action by Corporation *B* against the drawer, *A*, would be subject to *A*'s defenses on the underlying obligation between *B* and *A*. This follows from the previous discussion of due-course rights.[154] It is not of great moment if the payee has an alternative final payment action against the payor account institution, which could not invoke *A*'s defenses on the underlying obligations. It can make a difference, however, where no such alternative action is available, as when the payor account institution has conditioned the transfer on the right to revoke.

If Bank Two does not charge back and, as the funds claimant, sues Corporation *A* on *A*'s drawer's contract, *A* would not be able to raise defenses on its underlying obligation with Corporation *B*. When, as is normally the case, Bank Two is entitled to due-course rights, the possibility exists that Bank Two and Corporation *B* will agree that Bank Two should pursue the drawer to avoid *A*'s defenses on the underlying obligation, especially where Bank One's payment obligation cannot be invoked. This agreement could prove quite important to the drawer if its account with the payor account institution had not already been debited—if it had, the drawer would have a wrongful debit action against Bank One—since *A* would have to pursue *B* for any damages on the underlying obligation after making good on its drawer's contract to Bank Two. This path could be expensive and subject *A* to the risk of Corporation *B*'s insolvency.

Since the N.P.C. allows a corporate drawer to send a pay order without due-course rights by making an appropriate indication on the order,[155] the drawer and payee can bargain for defense cut-offs. Given this self-protection option, the possibility of accommodation between Bank Two and Corporation *B* is not disturbing.[156] Without due-course rights, Bank Two has to rely more heavily on its own customer's credit.

---

153. N.P.C. § 424(1); U.C.C. § 4-212(1).

154. See supra notes 118–23 and accompanying text.

155. N.P.C. § 103(3) provides that a funds claimant who meets the general requirements for due-course status, i.e. value, good faith and lack of notice of a defense, see id. § 104(1), still takes subject to the claims and defenses of the drawer on an order "on which the drawer states 'not entitled to due-course rights.'"

156. Since consumers are much less likely to bargain over such matters, id. § 103(3) does not allow consumers to create orders with due-course rights.

D. *Transmittal of Authorized Pay Orders: The Liability of Account Institution and Non-Account Institution Transmittors*

The N.P.C. provides that a "transmittor"[157] of a pay order must observe the "reasonable commercial standards of its business" in receiving, processing, presenting or transmitting an order.[158] Where an order is lost or delayed as a proximate consequence of the failure to observe such standards, the negligent transmittor is liable for damages to any person harmed. But the N.P.C. limits the maximum amount of damage to the amount of the order and denies recovery for any loss that would not have been avoided had the transmittor acted in accordance with reasonable commercial standards. Moreover, the injured party can recover consequential damages only if the transmittor has acted in bad faith.[159]

1. *Consequential Damages.* The N.P.C.'s consequential damages provisions differ from the common law treatment of such damages in *Evra Corp. v. Swiss Bank Corp.*[160] In *Evra*, the Seventh Circuit, reversing the judgment of

---

157. A transmittor is "any person which transmits or processes an order." Id. § 53(5). This definition includes an account institution, such as a bank, as well as a service bureau, switch, or communications service.

158. N.P.C. § 411(1) provides:

> A transmittor must act in accordance with the reasonable commercial standards of its business in
>
> (a) receiving, processing, presenting or transmitting an order, adjustment order or returned order whether for debit or credit, provided that this Section shall not be the basis for a claim that a transmittor is liable for an unauthorized order . . . .

The N.P.C. has special provisions requiring account institutions to exercise ordinary care in the timely transmission of orders. Id. §§ 50(6), 411(3). A transmitting account institution acts in a timely manner if it completes action before midnight of the next business day after receipt of the order—the "midnight deadline," id. § 50(6)—unless an earlier time is specified by applicable Fed rules, or clearing house or association agreements. Id. § 411(3). Action on pay orders is often necessary, whether or not required by system rules, before the midnight deadline, and it is possible the midnight deadline allows too much time. Nonetheless, it is difficult to arrive at a shorter time boundary that makes sense in all situations.

159. N.P.C. § 411(7) provides:

> The measure of damages under this Section for failure to act in accordance with reasonable commercial standards does not include consequential damages and shall not exceed the amount of the order reduced by an amount which could not have been realized by acting in accordance with reasonable commercial standards, plus interest, calculated on the basis of the average daily Federal Funds rate, as published by the Federal Reserve Bank of New York, except damages may include all actual damages proximately caused by a party which has acted in bad faith.

The Federal Communications Act of 1934 (FCA), Pub. L. No. 416, 48 Stat. 1064 (codified as amended in scattered sections of 47 U.S.C.), requires an interstate common carrier to file contracts, including limitation of liability provisions, as part of the tariff application made to the Federal Communications Commission (FCC). If the contract is approved, liability will be limited to the amount specified in the contract. 47 U.S.C. § 203 (1976). See Schaafs v. Western Union Tel. Co., 215 F. Supp. 419 (E.D. Wis. 1963); Komatz Constr., Inc. v. Western Union Tel. Co., 290 Minn. 129, 186 N.W. 2d 691, cert. denied, 404 U.S. 856 (1971). Insofar as the N.P.C. permits a transmittor's liability to extend to the amount of an order it may pose problems under the FCA if the transmittor is an FCC-regulated carrier with lower limits of liability in an approved tariff. Similar problems are raised for carriers regulated under different regimes such as airlines or motor vehicles.

160. 673 F.2d 951 (7th Cir.), cert. denied, 103 S. Ct. 377 (1982). See Miller & Scott, Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers, Annual Survey of the Uniform Commercial Code, 38 Bus. Law. 1129 (1983) (reviewing *Evra*).

the district court, refused to hold an intermediate bank, Swiss Bank Corp., liable to the drawer of a wire transfer, Hyman-Michaels, for $2.1 million in consequential damages resulting from the loss or mishandling of a $27,000 telex. As a result of Swiss Bank's negligence, the order was never transmitted to the corporate payee, Pandora Shipping Co., whose account was at Banque de Paris et des Pays Bas (Suisse) in Geneva, Switzerland. The telex represented a semimonthly installment payment on a ship charter. Pandora cancelled the charter when it did not receive payment by the due date, causing Hyman-Michaels consequential damage as a result of the steep rise in charter rates since the inception of the charter contract.

The Seventh Circuit denied the drawer recovery for three reasons. First, Hyman-Michaels waited until what was arguably the last day before payment was due to instruct its bank to transfer funds, and thus was contributorily negligent. Second, the drawer failed to "pull out all the stops" to make payment after it was notified that Pandora had not received payment, and thus failed to mitigate or avoid damage. Third, based on the contract law principles set out in *Hadley v. Baxendale*,[161] the court held that consequential damages were inappropriate since Swiss Bank had no notice of the special circumstances that gave rise to them. The contract law rationale was reinforced by the tort law principle that because Swiss Bank did not know what the magnitude of harm could be, it could not determine how much care to take.

The Seventh Circuit's approach to consequential damages depends on the facts of each case, such as whether there is negligence before the scheduled transfer, mitigation after the fact or notice of special facts. In contrast, the N.P.C. absolutely bars, absent bad faith, consequential damages for transmission failures.[162] The N.P.C.'s rule produces more certainty and avoids the impracticality of requiring transmittors to give special handling to orders when on notice of circumstances warranting such handling. The hard and fast N.P.C. rule lets the drawer, which is in the best position to assess the possible losses, take precautions against mishandling. For example, it could send the wire sufficiently in advance to assure timely receipt, take mitigating measures if the wire does not arrive, or purchase insurance.

This limitation on consequential damage liability for transmittors resembles in many respects the limitation on consequential damage liability for payor account institutions discussed previously.[163] Payor account institutions are liable for consequential damages on corporate wires only if the damage results from an intentional act, such as an unlawful hold or setoff placed on an account. For payor account institutions, as well as transmittors, good faith processing mistakes should not lead to liability for consequential damages. Neither the payor nor the transmittor is in as good a position as the drawer to

161. 156 Eng. Rep. 145 (Ex. 1854).
162. N.P.C. § 411(7) & comment 8.
163. See supra notes 109–12 and accompanying text.

know what turns on the timely arrival of a wire. The transmittor, as an intermediary, knows nothing about the underlying obligation, and in today's banking world the payor account institution is not likely to know much more. Accordingly, these parties cannot efficiently determine how much to spend on precautions or how much insurance to purchase, even assuming insurance would be available to cover the potential liabilities they could foresee. The payor account institution should be liable for consequential damages for intentional acts because such acts are not a matter of routine. The account institution should be expected to anticipate the substantial damages that might flow, for example, from placing a hold on an account. Similarly, if a transmittor acts in bad faith, it can anticipate the possibility, if not the extent, of damages.

The N.P.C., however, generally allows the payee to recover consequential damages from its own account institution—the receiving account institution—where the latter receives a credit for its customer but does not post the credit when required to do so.[164] As with the transmission failures of payor account institutions or transmittors, the failure of a receiving account institution to post a credit may result from a processing error or from a conscious policy decision, as, for example, when a bank does not post a very large wire because of its concern—subsequently proven wrong—that the transfer is mistaken or unauthorized. Unlike payor or transmitting account institutions, receiving account institutions are liable for consequential damages both for processing errors and intentional acts.

The receiving account institution's decision not to post resembles the intentional act of a payor account institution in placing a hold on an account. When these actions are taken wrongfully, both account institutions should be—and under the N.P.C. are—charged with the full consequences of such "intentional torts." Both institutions can easily avoid taking such acts. Furthermore, the receiving account institution is fully protected because it is required to allow its customers to withdraw funds only after payment is made, and can reject an order that it regards as likely to be unauthorized in order to protect itself from liability for giving funds to a wrong party.[165] But once it has accepted the order, the recipient should be charged with the consequences of the intentional act of not posting. It would be incongruous to make a payor account institution liable for the consequences of an unlawful setoff that

164. N.P.C. § 421(2) provides that where an account institution becomes a funds transferee on a pay order for its customer, the credit is available for withdrawal as of right "at the opening of the account institution's next business day following the business day on which it becomes a funds transferee." Id. § 421(2)(c).

N.P.C. § 421(4) establishes the measure of damages for failure to make funds available to a customer when such funds are withdrawable as of right. It provides:

> An account institution is liable to its customer for all actual damages including consequential damages, proximately caused by its failure to meet its obligation under this Section and such damages may include damage to credit and damages for arrest and prosecution, but may only include punitive damages when the account institution has acted in bad faith.

165. See infra notes 204–05 and accompanying text.

prevents a transfer from being effected, while at the same time exonerating a receiving account institution that unlawfully sets off a credit received for a customer.

However, the N.P.C.'s distinction between processing errors by receiving account institutions and those by others in the chain is more questionable. It may be argued that requiring receiving account institutions to post all credits they receive is not particularly burdensome and is significantly less burdensome than requiring payor account institutions or transmittors always to process wires in a timely fashion. The receiving bank, however, is in no better position than the payor or transmitting banks to take proper care or to adequately insure. It knows no more about the underlying obligation than do the other banks. At the same time, the drawer could check with the payee to make sure its bank has received the wire and that the credit has been posted. It therefore may be no more appropriate to award consequential damages for processing errors by receiving banks than for such errors by other account institutions.

2. *Liability of Non-Account Institution Transmittors.* The N.P.C.'s damage provisions for the mishandling of authorized wire transfers draw no distinction between transmittors that are account institutions and those that are not. The absence of such a distinction is appropriate. As the review of CHIPS and S.W.I.F.T. demonstrated,[166] these systems significantly limit their own liability for a mishandled wire transfer. In CHIPS, any loss of funds due to a "system" error is settled directly between the participants involved, without any responsibility on the part of CHIPS. Presumably, malfunction of the switch constitutes a "system" error.[167] S.W.I.F.T. assumes liability, but only up to a preestablished maximum and subject to a deductible.[168] Common carriers, such as those offering a telex service, also commonly limit their liability. These private system rules do not, however, conflict with the N.P.C.

Given that both private system rules and the N.P.C. almost completely preclude consequential damages against transmittors, transmittors should not be liable for significant damages for mishandling authorized orders. Moreover, in cases involving authorized orders, there should be no loss of principal since the order was not materially altered, but only delayed.[169] For interest losses, the N.P.C. provides funds claimants with a cause of action against any tortfeasor[170] without regard to whether the tortfeasor is an account institution. If the tortfeasor reimburses the funds claimant for interest losses but was not the party in possession of the funds during the period of delay, it can in turn recover the interest from any party that held the money during that

166. See supra notes 37–54 and accompanying text.

167. See supra note 45 and accompanying text.

168. See supra notes 53–54 and accompanying text.

169. A principal exception to this rule would be, for example, a case involving an order that is diverted to a wrong party that does not return the funds. This unauthorized order, however, is treated separately under the N.P.C.

170. N.P.C. § 411(1). Interest claims are to be based on the Federal Funds rate as published by the N.Y. Fed. Id. § 411(7).

period.[171] Moreover, the N.P.C. allows communication switches or other service providers that find these obligations burdensome to contract out of the N.P.C. rule and seek indemnification from participants or purchasers of their services.[172]

E. *Unauthorized Orders*

The N.P.C. has specific rules for allocating losses on unauthorized orders.[173] A pay order is unauthorized if it (1) is not initiated by the drawer or with the drawer's consent or authorization, or (2) is materially altered.[174] An alteration of an order is material if it does any of the following: (1) changes the amount; (2) changes the number, relation or identity of a party; (3) changes the account number of any party; (4) changes the identity of any account institution specified in the order; (5) completes an incomplete order otherwise than as authorized; or (6) changes the date, if specified, on which value is to be given on the order.[175]

Under these provisions, both fraudulent and erroneous wire transfers are unauthorized. A fraudulent transfer can be originated by either an impostor or a wrongdoer. For example, an impostor might send a written authorization to transfer funds, having forged the legitimate drawer's signature,[176] or might impersonate the drawer over the telephone. In addition, a wrongdoer could gain access to the legitimate drawer's terminal to send instructions. Unauthorized employees of the drawer or outsiders could perform such fraudulent transfers.

A wire authorized by the drawer can be fraudulently or erroneously altered after being legitimately authorized. For example, employees of the payor account institution, or any subsequent transmittor, might intentionally or inadvertently change the drawer's instructions and send the transfer in the wrong amount, to the wrong receiving bank or to the wrong payee. Fraudulent transfers can also occur if outsiders gain unauthorized access to the terminals, computers or communication lines of the payor account institution or subsequent transmittors.

---

171. See N.P.C. § 209 ("The funds claimant on an order may recover from any person the amount by which such person has been unjustly enriched by payment of such order.").

If, for example, a communication service (CS) delayed transmission of a telex from the correspondent to the payee's bank, the correspondent would continue to hold funds during the period of delay, assuming the correspondent was to settle by the payee's bank debiting its account. If the payee, as funds claimant, recovered from CS, CS could in turn recover from the correspondent any interest earned during the delay on the principle of unjust enrichment.

172. The N.P.C. does not govern the validity of sales or service contracts. This matter remains within the province of the U.C.C. See U.C.C. §§ 1-103, 2-719(3).

173. Unlike the U.C.C., the N.P.C. separates the treatment of authorized and unauthorized orders. N.P.C. §§ 100–157 contain the basic rules for authorized orders, while §§ 200–210 deal with unauthorized orders. See supra note 90.

174. N.P.C. § 54(1), quoted in relevant part supra note 90.

175. N.P.C. § 54(3), quoted in relevant part supra note 90.

176. See Securities Fund Servs., Inc. v. American Nat'l Bank & Trust Co., 542 F. Supp. 323 (N.D. Ill. 1982).

When an order is determined to be unauthorized, the N.P.C. abandons contractual principles for allocating the risk of liability among the drawer and payor and transmitting account institutions, and applies principles drawn from tort law. This Section first discusses the N.P.C.'s allocation of liability between the drawer and the payor account institution in the case of orders the drawer did not authorize. It then analyzes the N.P.C.'s provisions allocating losses when an authorized order is subsequently altered materially.

1. *Allocating Losses on Orders Unauthorized By the Drawer: The Liability of the Drawer and the Payor Account Institution.* In the case of an order initiated without the authorization of a corporate drawer, the N.P.C. provides that losses must be allocated exclusively between the payor account institution and the drawer. As between the payor account institution and subsequent parties, the payor account institution can best avert the loss, since it establishes the procedures and protocols by which orders are entered to the accounts of its customers. When an order is unauthorized by the drawer, the N.P.C. therefore places no responsibility on subsequent transmittors or account institutions to detect the loss.[177] That is to say, when the payor account institution is found liable for an order unauthorized by the drawer, it cannot shift the loss to or seek contribution from another party.

While the N.P.C. provides that a payor account institution "agrees with its customer that it will not . . . pay or transmit for payment an unauthorized pay order,"[178] the drawer may be solely or substantially responsible for an unauthorized transfer. Therefore, the payor account institution should not be liable for all payments on unauthorized orders.

The N.P.C. recognizes only two circumstances in which the payor account institution is absolutely liable for all payment or transmissions of orders unauthorized by the drawer. First, the N.P.C. provides that a corporate drawer can never be liable for losses on a wire transfer if the transfer takes place through a method of access to the drawer's account—in N.P.C. terminology, through an "access device"—that it has not authorized.[179] For example, if a corporation has authorized access to its account only by computer terminal, and the transfer is originated by telephone or written instruction, the corporation is not liable for the improper transfer. Second, the drawer cannot be liable where the payor account institution has paid the order after receiving notice that a particular fraudulent transfer will take place.[180] These two rules

177. No protection is given to the payor account institution under N.P.C. § 204.

178. Id. § 101(1).

179. N.P.C. § 200(1) provides that a "person shall not be liable as drawer to its account institution or any purported funds claimant for an unauthorized order and its account shall not be charged for the order if the order is (a) not initiated by an accepted access device." "An access device is a card, check, code, passbook, or any other means of access to an account, or any necessary combination thereof, that may be used to initiate an order." Id. § 50(18) (emphasis omitted).

One can accept an access device by using it or by obtaining control over it. No written authorization agreement is required. Id. § 201(1)(a).

180. N.P.C. § 200(1)(b) provides there can be no liability as drawer where an order is "paid by a payor account institution after its receipt of notice that the order is unauthorized."

rest on the theory that the account holder should be able to limit risk by restricting access to its account. The N.P.C. recognizes that some means of access are more secure than others, and that once the payor account institution is actually informed of an impending fraud, it is in the best position to avert the loss at the cheapest cost.

Where neither of these two absolute bars to drawer liability comes into play, the N.P.C. provides two tort formulations to allocate the loss based on the relative culpability of each party and the relative ability of each party to avert the loss.

First, if the drawer is per se negligent as specified by the N.P.C., it is liable for the loss if: (1) its negligence has contributed in *some way* to the loss and (2) the party seeking to enforce the order—for example, the payor account institution—has acted in good faith and has not itself fraudulently and materially altered the order.[181] As presently drafted, the N.P.C. identifies only two acts of per se negligence for pay orders: (1) failure to report a lost or stolen access device and (2) the act of giving a personal identification or security code to another person who has initiated the unauthorized order.[182] Other acts may merit addition to the per se list. For example, perhaps the N.P.C. should make employers responsible for the fraudulent acts of their employees as does U.C.C. section 3-405, an approach already taken by the N.P.C. for written draw orders like checks.[183]

Second, if the drawer has not been negligent per se under the N.P.C. but has been generally negligent at common law the drawer bears the loss if: (1) its negligence *substantially contributed* to the unauthorized issuance of the order, and (2) the payor account institution acted in good faith, in accordance with the reasonable commercial standards of its business, and did not fraudulently or materially alter the order.[184] The drawer can be generally negligent either under common law standards or under special rules, modelled after U.C.C.

---

181. N.P.C. § 202(1) provides:

Unless the drawer shows that the acts specified below in no way contributed to any loss resulting from an unauthorized order or unless a person seeking to enforce the order has acted in bad faith or has itself fraudulently and materially altered an order, a person is precluded from asserting as drawer that an order is unauthorized, when[:]

. . . .

(c) in the case of a pay order, a personal identification or other security code is voluntarily given by the drawer to another person who initiates an unauthorized order.

(d) in all cases, where a person fails promptly to notify the payor account institution of the loss or theft of an access device after discovery thereof.

182. Id. § 202(1)(c), (d).

183. Id. § 202(1)(a)(iv).

184. N.P.C. § 202(2) provides:

A person is otherwise precluded [otherwise than under subsection (1)] from asserting as drawer that an order is unauthorized if the person's negligence substantially contributed to the order becoming unauthorized, unless a . . . funds transferor gave value for or on or a payor account institution paid an order in bad faith or other than in accordance with the reasonable commercial standards of its business, or fraudulently and materially altered an order.

section 4-406, for the failure of the drawer to inspect a statement and detect unauthorized orders.[185]

The N.P.C. requires the drawer generally to exercise "reasonable care and promptness" to examine the statement, discover orders that it did not authorize and promptly report the discovery.[186] If the drawer fails to exercise reasonable care, it is liable for any loss on the unauthorized order that the account institution establishes resulted from the drawer's failure, such as the inability to retrieve funds from a wrongdoer's account.[187] Such a failure also results in liability for any subsequent unauthorized orders paid by the account institution after the customer has had a statement "furnished or made available"[188] for sixty calendar days,[189] if the later orders are made by the wrongdoer that initiated the unauthorized order reflected on the statement. Neither of these bars to drawer recovery is operative, however, if the account institution cannot show that it acted in good faith and in accordance with the reasonable commercial standards of its business in paying the unauthorized order in question.[190]

In sum, regardless of whether the drawer has been negligent, per se or otherwise, it can avert liability in two ways. First, it can show that its negligence was not the cause of the order's unauthorized issuance, and therefore not the cause of the loss. Second, even if the causation test is met, the drawer is not liable for the loss if the payor account institution cannot show that it was without contributory fault.

Under the N.P.C., the drawer's causation and contributory fault defenses are more difficult to sustain when the drawer has been negligent per se rather than generally negligent. Where the drawer has been per se negligent, it must show that its negligence *in no way* contributed to the loss,[191] and the payor account institution is considered contributorily negligent only when it has acted in bad faith.[192] Where the drawer has been generally negligent, it need only meet the lesser burden of showing that its negligence did not *substantially*

---

185. Id. § 203; cf. Nagle v. LaSalle Nat'l Bank, 472 F. Supp. 1185, 1191-92 (N.D. Ill. 1979) (customer under no duty to report, based upon inspection of statement, that a wire had been authorized by only one of two necessary parties).

186. N.P.C. § 203(1).

187. Id. § 203(2)(a).

188. Id. § 203(2)(b).

189. Id. The N.P.C. allows 60 days, as compared with the current U.C.C. rule of 14 days for checks. U.C.C. § 4-406(2)(b). The rule for checks anticipates that a customer has written orders that can be reconciled with the statement. In a somewhat related area, error resolution, TILA, 15 U.S.C. § 1666(a) (1976 & Supp. V 1981), and EFTA, 15 U.S.C. 1693f(a) (Supp. V 1981), allow 60 days to complain about a statement error. Where written orders are not returned to a customer, which will be the case for truncated checks as well as electronic transfers such as wire transfers, reconciliation is often more difficult. In the wire transfer context, where there can be no reconciliation with written orders, customers should have a longer time in which to inspect a statement and detect unauthorized orders.

190. N.P.C. § 203(3). One additional defense, a one-year statute of limitations, id. § 207, can be raised against the drawer.

191. Id. § 202(1).

192. Id.

contribute to the loss,[193] and the payor account institution is considered contributorily negligent if it acted in bad faith *or* failed to act in accordance with reasonable commercial standards.[194] In both cases the payor account institution is liable for its own fraudulent and material alteration of the order.

The N.P.C. formulates these different standards on the basis of two factors: the drawer's culpability and its related ability to avert the loss, and a concern over judicial bias against account institutions in suits involving conflicts with their customers. The drawer is more culpable where it is negligent per se because it is cheaper for the drawer to avert an act of per se negligence than it is for the payor account institution to avoid being generally negligent. For example, it is an act of per se negligence for the drawer to fail to report promptly the loss or theft of an "access device," such as a terminal that could be used to initiate pay orders.[195] Even if the payor account institution's security measures for determining the legitimacy of a terminal-originated instruction fell below reasonable commercial standards—thus making the payor account institution generally negligent—it would usually be cheaper to avert loss through a drawer-initiated report that a terminal is lost or stolen. In this case, the N.P.C. imposes the loss on the payor account institution only if the loss or theft of the terminal in no way contributed to the loss or if the payor account institution acted in bad faith or fraudulently and materially altered the order.

The N.P.C.'s treatment of liability for drawer-unauthorized orders also reflects the concern that courts—judges or juries—will tend to conclude that account institutions must not have acted in accordance with reasonable commercial standards if a loss has occurred. Courts are likely to be impressed with the failure of a defendant account institution to adopt a potential security measure even if the defendant would not be required to take the measure under a rigorous analysis of negligence law. The N.P.C. guards against this possibility by denying a per se negligent drawer the defense of the payor account institution's failure to observe reasonable commercial standards and by requiring only *some* causal connection between the drawer's per se negligence and the loss.[196] The N.P.C. also limits the possible tendency of courts to find account institutions negligent by providing that "[m]ere payment of an unauthorized order is not failure to act in accordance with reasonable commercial standards."[197]

2. *Liability of Parties for Materially Altered Orders.* While previous Sections have examined transmittor liability under the N.P.C. for drawer-

193. Id. § 202(2).

194. Id.

195. Id. § 202(1)(d).

196. There is nothing improper in designing statutory rules in contemplation of how the rules may be used or abused by the various actors in the legal system. Indeed, the development of statutory law in the commercial field has been motivated in part by the desire to constrain common law judges. See generally Scott, supra note 10.

197. N.P.C. § 203(3).

authorized orders that were lost or delayed in transmission,[198] and discussed the N.P.C.'s treatment of orders unauthorized by the drawer, this Section describes how the N.P.C. allocates the risk of loss for pay orders that are initially authorized by the drawer but subsequently become unauthorized due to material alteration. In these cases, the legitimate payees—funds claimants—do not, for various reasons, receive the correct payment. For example, the wire may be diverted to the wrong bank or wrong payee, due to fraud or mistake. Even if the payee receives the order, it may be in the wrong amount.

a. *Principles of Liability.* Transfers can be materially altered either by the transmittor itself or by an outsider intervening between a transmittor and tranmittee. The N.P.C. treats these two kinds of materially altered orders differently.

First, the N.P.C. provides that a transmittor is strictly liable "to all prior transmittors and all subsequent transmittees if it has materially altered an order."[199] This provision serves to make any transmittor, whether or not it is an account institution, strictly responsible for transmitting the same order it receives.[200] Unlike the provisions concerning authorized orders, this provision could result in substantial losses for transmittors, such as telex services or other communications firms, that are not account institutions. However, it makes little sense to hold such parties less responsible than account institutions for their material alterations. If this burden is onerous, transmittors are free to seek indemnity from their customers.[201]

Second, the N.P.C. allocates loss from material alteration by an "interloper"—that is, a wrongdoer intervening between a party and the immediately prior funds transferor of an order. The N.P.C. provides that a "funds transferee or payor account institution is liable to any funds claimant if it fails to give value on a pay order as transmitted to it by the drawer, payee or last prior funds transferor to transmit the order."[202] The effect of this provision is to hold responsible for the loss the first account institution to receive an order materially altered by an interloper.

Thus, a transmittor that itself materially alters an order is strictly liable to any prior or subsequent parties. However, if an order initially issued in correct form by a transmittor is altered by an interloper prior to its receipt by the next subsequent transmittee, the transmittee bears the responsibility for discovering the alteration. However, the transmittee is liable for an interloper's alteration only if it is a funds transferee or a payor account institution.[203] A

198. See supra notes 157–63 and accompanying text.

199. N.P.C. § 204(2).

200. As to proof of whether a particular account institution materially altered an order, see supra note 119.

201. While § 3 of the N.P.C. limits the ability of account institutions to contract out of negligence liability or limit damages, see infra notes 228–35 and accompanying text, these provisions are not applicable to transmittors that are not account institutions. Their ability to contract out is limited only by common law and applicable common carrier statutes.

202. N.P.C. § 204(3).

203. N.P.C. § 204(3) establishes liability only for a funds transferee or a payor account institution. A non-account institution transmittor cannot be either of these parties.

transmission service that only passes on the altered message and not the funds incurs no liability. The N.P.C. places responsiblity on the next succeeding account institution on the theory that transmission services, such as communication switches, should have no responsibility for checking the validity of orders. The next succeeding acccount institution, which handles both the funds and the message, is in the best position either to discover the alteration or to choose not to accept messages over the transmission service in question. Two examples illustrate the operation of the transmittor and interloper provisions.

First, suppose Corporation *A*, the drawer, issues an order to its payor account institution, Bank One, to send an order for $2 million to Corporation *B* at Bank Two. An interloper intercepts the order between Corporation *A* and Bank One and alters it to provide that $4 million be sent from Corporation *A* to Interloper Corporation at Bank Two. Bank One debits Corporation *A* for $4 million and Interloper Corporation receives, and withdraws, $4 million from its account at Bank Two. Bank One, a payor account institution, has not given value on the order as transmitted to it by Corporation *A*, the drawer, since it has debited Corporation *A*'s account and transmitted an order for $4 million rather than $2 million. It is thus liable for $2 million to Bank Two, a funds transferor to Interloper Corporation, or to Corporation *B*, the payee, either of which may be funds claimants, depending on whether Bank Two has made good on the original $2 million order to Corporation *B*. In addition, Bank One must recredit Corporation *A* for $2 million since it has improperly debited Corporation *A*'s account for that amount.[204] As noted above, the theory of apportioning loss to Bank One is that it is in the best position to avert the loss.

Contrary to the N.P.C. position, an argument can be made that Corporation *A* should be responsible for the loss since it chose the method of communication and should thus accept the risk that the communication is vulnerable to interception and alteration. However, the receiver, Bank One, is also a party to the communication and chose to accept the method of communication. The N.P.C. assigns risk to the receiver rather than the sender on the theory that the receiver is likely to be better able to detect an alteration. Obviously, parties further down the line, such as Bank Two, are in no position to avert the loss.

Of course, another candidate for liability in this situation is the transmittor of the intercepted message—the owner of the communication line over which the instruction was moving. While it is appropriate to make non-account institution transmittors liable for material alterations made by their employees, it is too onerous to make them responsible for alterations by outsiders. The N.P.C. takes the view that transmittors that only transfer messages and not funds should not be responsible for losses due to interlopers. Instead, where an interloper is involved, the loss should fall on the next

204. N.P.C. § 101(4) provides that "[a] payor account institution shall be liable to its customer for the amount of any debit wrongfully made to the customer's account."

subsequent account institution since it accepted the prior account institution's choice of communication service and thus accepted that service's level of security against interception. Moreover, if security measures are taken, such as the inclusion of an algorithm within the message that changes with any alteration of the message, the account institution is in the best position to determine whether an alteration has occurred.

Second, suppose that Corporation *A* sends the same $2 million instruction, which, this time, reaches Bank One in unaltered form. Bank One sends the message over BankWire, but before it reaches the BankWire switch, it is altered and Interloper Corporation receives and withdraws $4 million from its account at Bank Two. Bank One settles for the message through an adjustment in correspondent accounts. In this situation, the N.P.C. makes Bank Two responsible for the loss because, as a funds transferee (having received funds from Bank One), it failed to give value on the order as transmitted to it by Bank One, the last prior funds transferor. While BankWire is a transmittor, it is neither a funds transferee nor the party responsible for the alteration, and thus is not responsible for the loss. Again, the loss falls on the receiver, Bank Two, and not on the sender, Bank One. If the message had been sent by FedWire, and was altered between Bank One and the Fed, the Fed, as a funds transferee—it has debited Bank One's account—would be responsible for the loss. Unlike the BankWire switch, which only moves the message, FedWire moves both the message and the funds.

Just as in the BankWire example, if the wire transfer had been by telex, and an interloper had altered the message after it had left Bank One but before it had reached Bank Two, Bank Two would be liable. Bank Two's position is somewhat more difficult here than it is in the BankWire case, because telex is not a system used exclusively for funds transfers. Moreover, unlike BankWire, which is owned by its users, telex is not subject to Bank Two's direct control and Bank Two has no control over how telex messages are safeguarded. Bank Two may use telex machines to receive a variety of messages, but may not want to accept telex transfers because of a concern with system security and its potential liability.

However, imposing liability on Bank Two, even if it uses telex, is not unfair. Bank Two always has the option of rejecting telex "presentments." Under the N.P.C., any person to whom an order is presented can without dishonor require "reasonable coding of the message," reasonable identification of the person transmitting the order, evidence of the person's authority to transmit if that person is transmitting for another person, and reasonable evidence that the order is authorized.[205]

---

205. N.P.C. § 412(5) provides in part:

A transmitee or any drawee may, without dishonor, require: (a) as to all orders presented, (i) reasonable identification of the person transmitting the order; (ii) evidence of a person's authority to transmit if transmitting for another; (iii) reasonable coding of the message; and (iv) reasonable evidence that the order is authorized.

b. *Causes of Action on Materially Altered Orders.* Having examined the basic liability rules for orders that are authorized by the drawer but later become unauthorized, the discussion turns to the causes of action to enforce these liability rules. The case law under the U.C.C. in the analogous area of forged endorsements on checks displays great confusion.[206] The N.P.C. provides that liability can initially be enforced only through a conversion action brought by the funds claimant against the converter (the person paying the wrong party), or, if the drawer has reimbursed the funds claimant for the amount of the converted order, by the drawer against the payor account institution.[207] Parties liable in the initial action can then transfer the loss to the parties ultimately responsible. Three examples illustrate these actions.

First, suppose Corporation *A*'s message to Bank One to transfer $2 million to Corporation *B* at Bank Two is sent over FedWire and materially altered by an employee of the Fed with the result that a $4 million funds transfer is received and withdrawn by Dummy Corporation at Bank Two. Suppose further that the Fed has debited Bank One and credited Bank Two for $2 million. Corporation *B*, as a funds claimant, can seek redress through

---

206. On the issue of whether a drawer can sue a collecting bank where a drawer has not authorized an order, compare Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co., 345 Mass. 1, 184 N.E.2d 358 (1962) (no right of action against collecting bank), with Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978) (U.C.C. § 4-207 authorizes direct suit by drawer against collecting bank). On the issue of whether a "true owner" can sue a depository bank for conversion, compare Denn v. First State Bank, 316 N.W.2d 532 (Minn. 1982) (no cause of action allowed), with Cooper v. Union Bank, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973) (cause of action allowed). See also Girard Bank v. Mount Holly State Bank, 474 F. Supp. 1225 (D.N.J. 1979) (allowing a depository bank, once liable to a payor bank, to sue the drawer on an order unauthorized by the true owner).

207. N.P.C. § 205 provides, in relevant part:

> (1) [A]ny account institution which gives value on a pay order to any person except the funds claimant is liable to the funds claimant unless such person has already discharged its liability under Section 204 or the funds claimant has been reimbursed by the drawer under subsection (3). No other account institutions or parties are liable to the funds claimant under this subsection.
>
> . . . .
>
> (3) The drawer of an order which is payable to a specified person and which has become unauthorized by payment to a wrong person is entitled to recover the amount of the order, unless precluded, from the payor account institution. Any drawer receiving such recovery must issue a substitute order or otherwise satisfy the claim, on the same terms, to the funds claimant on the original order.

As indicated in the text, a funds claimant can bring an action against a party that has paid the wrong person. The person to be paid on a wire transfer may often be identified by name *and* account number. Suppose the credit is posted to the right account number but not to an account in the name of the party named in the order, or the right name but wrong account. As to written orders, N.P.C. § 22(1)(b), following U.C.C. § 3-118(c), provides that "words control figures except that if the words are ambiguous, figures control." Given the industry practice of acting on numbers, it makes sense for the rule on wire transfers to be the reverse, and N.P.C. § 22(2) provides that "[a]s to non-written orders, figures control words except that if the figures are ambiguous, words control." Since only a funds claimant—the person entitled to but not receiving payment—can bring an action, this issue should only be raised in a case where a legitimate drawer has first authorized payment. Cf. Securities Fund Servs., Inc. v. American Nat'l Bank & Trust Co., 542 F. Supp. 323 (N.D. Ill. 1982) (receiving bank denied summary judgment where it posted an order unauthorized by the drawer to the correct account number but wrong account name).

two means. On the one hand, Corporation *B* can recover $2 million from Bank Two, the converter that wrongfully gave value to Dummy Corporation.[208] This result leaves Bank Two out of pocket for $4 million, since it has given Dummy Corporation $4 million and Corporation *B* $2 million, but received only $2 million from the Fed. Under the first liability principle, Bank Two should now be able to recover $4 million from the Fed, since the Fed was a transmittor responsible for the material alteration. Thus, the Fed is ultimately responsible for the $4 million loss.[209]

Alternatively, Corporation *B* may receive a payment from the drawer on the original $2 million obligation. The drawer is free not to reimburse the funds claimant. Since it has paid the order once, the drawer should not be forced into pursuing a loss recovery. If the drawer accommodates the funds claimant, however, the drawer can seek reimbursement for the second $2 million payment from its payor account institution, Bank One, based on Bank One's obligation to effect payment on an authorized order. At this point, Bank One is out of pocket $2 million, having only debited its drawer's account for the first $2 million order, and Bank Two is out of pocket $2 million, having given Dummy Corporation $4 million but having received only a $2 million credit from the Fed. Under the first liablility principle, each bank, as a funds claimant, can then sue the Fed for $2 million, the amount of loss due to the Fed's material alteration. Under either alternative, the Fed would be able to pursue its own employee and Dummy Corporation for the $4 million loss.[210]

Second, suppose that Corporation *A* asks Bank One to transfer $2 million to Corporation *B* at Bank Two. Bank One mistakenly sends the $2 million to Bank Three through FedWire for the account of Mr. Lucky, who takes the money and runs. The Fed debits Bank One and credits Bank Three for $2 million. Corporation *B*, as funds claimant, can recover the $2 million from Bank Three—the converter—which can in turn recover under the first basic liability rule from Bank One, the transmittor that materially altered the order.[211] Alternatively, if Corporation *B* gets a second $2 million payment from Corporation *A*, Corporation *A* can recover the $2 million from Bank

---

208. This action would be brought under N.P.C. § 205(1). Under N.P.C. § 205(2), which establishes damages for conversion, Corporation *B* can recover damages up to "the amount of the order as paid." In this case, since Bank Two paid $4 million to the wrongdoer, Corporation *B* can recover the $2 million to which it is entitled.

209. Bank Two's action would be brought under N.P.C. § 204(2). Under N.P.C. § 204(4), which establishes damages under § 204(2), Bank Two can recover up to "the amount of the order paid." In this case, since Bank Two paid $4 million to Dummy Corporation, it can recover this amount from the Fed.

210. N.P.C. § 54(8) provides that "[a]ny person who without authority initiates or transmits an order is responsible for the order to any person who in good faith pays the order or who gives value on or in exchange for the order." This language follows U.C.C. § 3-404(1). See also N.P.C. § 209.

211. Under N.P.C. § 205(1), Corporation *B* can recover against Bank Three, since Bank Three is a transmitting account institution. Bank Three can recover against Bank One under N.P.C. § 204(2), since Bank One is a transmittor responsible for the material alteration of an order.

One,[212] which has no further recourse, except to pursue Mr. Lucky, since it was responsible for the material alteration.

Third, suppose that Corporation *A*'s instruction to transfer $2 million to Corporation *B* at Bank Two is sent over the CHIPS communication system, but before it reaches the CHIPS computer an interloper alters it to provide for a $4 million credit to Interloper Corporation at Bank Three. Full settlement of $4 million occurs through net settlement, with Bank One a debtor and Bank Three a creditor on the $4 million order. Corporation *B*, as the funds claimant, can recover $2 million from Bank Three, which paid the order to the wrong person. Bank Three is left with the loss under the second basic liability rule—except as against Interloper Corporation—since as a funds transferee, having received settlement through CHIPS, it did not give value on the order as transmitted to it by the last prior funds transferor, Bank One. Alternatively, if Corporation *A* pays Corporation *B* $2 million, and recovers the $2 million from Bank One, Bank One can in turn seek recovery from Bank Three.[213]

As can be seen from these examples, the N.P.C.'s basic liability principles for material alteration and interloper fraud operate together with the actions for conversion to apportion loss. Only two initial causes of action—funds claimant against converter or drawer against payor account institution—can be brought. The N.P.C. precludes other possible causes of action, such as drawer against converter or funds claimant against payor account institution. The two available actions strike a balance between the desirability of furnishing the funds claimant with a convenient action and the undesirability of relying on several actions to allocate loss. Moreover, the limitation to two initial causes of action simplifies the administration of the system for subrogating defenses described below.

The N.P.C. takes the position that in most cases it is easier to sue the converter than the payor account institution since the converter is often the the funds claimant's own account institution. The payor account institution often will be more distant geographically and more resistant to a claim by a noncustomer. For the same reason, the N.P.C. allows only the drawer to sue the payor account institution. It should almost always be more convenient for the drawer to sue its own agent than to sue an unknown and possibly more distant account institution converter.

The N.P.C.'s policy favoring convenience generally is consistent with a policy of avoiding multiple lawsuits. As the third example illustrates, a suit by the funds claimant against the converter ends a case involving interloper fraud, since the converter is liable under the basic liability rule. As the first and second examples demonstrate, however, the first action may be followed by subsequent suits where the alteration is made by a transmittor and not by

212. Corporation *A* can recover against Bank One under N.P.C. § 205(3).

213. Bank One, by reimbursing the funds claimant, becomes the funds claimant and can recover against Bank Three under N.P.C. § 204(3).

an interloper. The N.P.C. assumes that interloper frauds or mistaken diversions of funds to wrong parties by payee account institutions occur more frequently than material alterations by transmittors.

c. *Defenses.* The N.P.C.'s limitation on causes of action also makes possible a sensible treatment of defenses in cases involving initially authorized orders that later become unauthorized.[214]

Where a drawer authorizes an order that later becomes unauthorized by fraud or mistake, and seeks redress from the payor account institution after reimbursing the funds claimant, the N.P.C. allows the payor account institution to raise two defenses. The N.P.C. provides for a three-year statute of limitations from the time a statement is furnished or made available.[215] This gives the drawer ample time to obtain notice of an incorrect transfer either directly from the statement or by way of a complaint from the funds claimant.[216]

The second defense arises out of the drawer's duty to inspect a statement, which was discussed previously as it applied to orders not authorized by the drawer.[217] The same duty also exists, to a limited extent, for orders that are initially authorized by the drawer but later become unauthorized. The drawer's duty arises when such orders can be detected from an inspection of the statement.[218] A comparison of two cases illustrates the distinction. In the first case, the drawer has ordered its account institution, Bank One, to send a $2 million transfer to Corporation *B*. Instead, due to fraud or mistake on the part of Bank One's employee, $4 million is sent to Corporation *C*. In the second case, Bank One sends the $2 million to Corporation *B*, but the order is diverted to Corporation *C* due to fraud or mistake further down the line. In the first case, the drawer should be able to detect the unauthorized order from the statement, since the drawer's account was debited for $4 million rather than $2 million. In the second case, however, the statement does not reflect the unauthorized order. It shows a $2 million debit and—if it shows any beneficiary—identifies Corporation *B*. Only in the first case, therefore, could Bank One raise the defense of failure to inspect a statement.

---

214. The N.P.C.'s treatment of the payor account institution's defenses against the drawer in cases involving orders never authorized by the drawer is discussed supra notes 181–91 and accompanying text.

215. N.P.C. § 207 & comment 1.

216. Id. §§ 207, 208.

217. See supra notes 185–91 and accompanying text.

218. N.P.C. § 203(1) provides:

> Notwithstanding any other provision of this Code, a customer must exercise reasonable care and promptness to examine any statement furnished or made available by its payor account institution reflecting debits or credits to its account and to discover any orders not authorized by it or materially altered and must notify the payor account institution promptly after discovery thereof . . . .

N.P.C. § 203(1) requires the drawer to exercise "reasonable care" in inspecting a statement and in discovering materially altered orders. When the alteration is not reflected in the statement, as would occur, for example, if the beneficiary were changed by an interloper after the order was transmitted by the payor account institution, reasonable care does not require the detection of the alteration from an examination of the statement.

Where a funds claimant seeks recovery on an unauthorized order against the converter, the converter can defend on the grounds of the negligence of the funds claimant.[219]

For written draw orders, such as checks, the N.P.C. specifies certain per se acts of negligence by funds claimants that the converter can raise as a bar to suit. For pay orders, however, it specifies none. Therefore, the converter's only defense is that the funds claimant has been generally negligent, and that this negligence has substantially contributed to the conversion. The N.P.C. also provides, however, that a funds claimant is presumed not to be negligent if it does not obtain "control" over an order.[220] This presumption is of great significance in cases involving pay orders, since a payee is never in possession of the order itself, but rather only of the funds that are "pushed" to it by the order. However, the converter can overcome the presumption. For example, if a payee on a pay order gave the drawer faulty information, such as a misspelled name, the converter could assert such negligence as a defense if it substantially contributed to the loss.

Only the payor account institution can raise the three-year statute of limitations or drawer's failure to inspect a statement[221] and only the converter can raise the funds claimant's negligence.[222] This distinction creates the possibility of different litigation outcomes depending on which cause of action is pursued.

Suppose the drawer has inspected its statement and therefore is not subject to the drawer negligence defense of the payor account institution. A negligent payee, which, if it were the funds claimant, ordinarily could not recover against the converter, might recover fully by arranging for a second payment from the drawer and having the drawer sue the payor account institution to recover its overpayments. In this way, the loss that should be borne by the negligent payee is initially shifted, with the cooperation of the drawer, to the payor account institution. Furthermore, while the payor account institution can, as a funds claimant by subrogation, recover from the converter, this action leaves the loss with the converter rather than the negligent payee.

Alternatively, suppose the drawer has failed to inspect its statement and is therefore barred from recovering for the loss from the payor account institu-

---

219. N.P.C. § 206(2) provides:

> A funds claimant is precluded from recovering for an order on which it gives value to a wrong person if the funds claimant is negligent and such negligence substantially contributes to the wrongful giving of value, unless the person gives value to the wrong person in bad faith or other than in accordance with the reasonable commercial standards of its business or has fraudulently and materially altered the order. A funds claimant is presumed not to be negligent if it does not obtain control over an order.

220. Id. Of course, for a written draw order such as a check, the rule differs. Once a check is received by a funds claimant, such as a payee or endorsee, it is an instrument in the funds claimant's possession and, appropriately, the funds claimant bears the responsibility for safeguarding the check against loss or improper transfer.

221. Id. § 203.

222. Id. § 206.

tion. If the funds claimant has not been negligent—leaving the converter with no defense—the drawer can avoid the loss of a second payment to the funds claimant by arranging for the funds claimant to sue the converter. Again, the loss is left with the wrong party—the converter rather than the drawer.

In order to prevent such results, the N.P.C. provides for the subrogation of defenses. Where the drawer seeks recovery from the payor account institution, the payor account institution can raise any defenses that the converter might have had against the funds claimant. And where the funds claimant sues the converter, the converter can raise any defenses that the payor account institution might have had against the drawer.[223]

Even though the N.P.C. makes the payor account institution's defenses available to the converter, the converter would have more difficulty raising the defense of failure to inspect a statement than would the payor account institution. The converter has no facts of its own and must engage in discovery of information from both the drawer and the payor account institution. For similar reasons the payor account institution would have more difficulty raising the funds claimant's negligence than would the converter. This cost is justified, however, by the convenience of allowing two alternative causes of action.

The subrogation of defenses is a necessary concomitant to alternative causes of action. It ensures that losses are left with the appropriate parties. As noted above, the subrogation approach would be significantly complicated by allowing additional causes of action, such as actions by the drawer against the converter or the funds claimant against the payor account institution. By limiting causes of action, the N.P.C. seeks to avoid the problems raised by recent U.C.C. cases that allow common law causes of action of all types against all parties.[224]

The traditional tort system is based on one of three alternative formulations: (1) strict liability with a contributory negligence defense; (2) per se or general negligence liability with a contributory negligence defense; or (3) comparative negligence.[225] Under the N.P.C. the system is more complex.

---

223. N.P.C. § 208 provides:

(1) In any case where the drawer seeks recovery from the payor account institution under Section 205(3), the payor account institution may raise any defense that the person giving value to a wrong person might have had as against a person to whom the order was payable.

(2) In any case where the funds claimant seeks recovery from a person giving value to a wrong person under Section 205(1), the person so giving value may only raise a defense that the payor account institution might have had as against the drawer.

224. See, e.g., Sun 'n Sand, Inc. v. United Cal. Bank, 21 Cal. 3d 671, 502 P.2d 920, 148 Cal. Rptr. 329 (1978). N.P.C. § 210 further ensures this result by providing that "[t]he causes of action against and defenses of account institutions on unauthorized orders set forth in Part D [Part D covers unauthorized orders] are exclusive and none other shall be permitted, but this Section shall not itself limit the rights and liabilities of parties on the underlying obligation." This significantly curtails the import of common law causes of actions and defenses through the authority of supplemental principles of law. See U.C.C. § 1-103.

225. The comparative negligence rule apportions losses in cases where the defendant is either negligent or strictly liable. See e.g., Daly v. General Motors Corp., 20 Cal. 3d 725, 737-38, 575

Viewed as a whole, the N.P.C. tort system, based on the U.C.C. system, allocates liablility for unauthorized orders by creating a distinctive amalgam based on the elements of the traditional tort system. For example, particular defendants (account institutions) are strictly liable for some accidents (unauthorized orders) but can defend on the basis of the contributory negligence of the plaintiffs (drawers or funds claimants). Plaintiffs that are not per se negligent can nevertheless avoid liability if the defendants are negligent.

Leaving aside administrative costs, both the N.P.C. and traditional tort systems should produce equally efficient results using conventional perfect market assumptions.[226] In the case of corporate wire transfers, these assumptions should not deviate significantly from reality because of the large number and sophistication of the parties involved. Moreover, from a loss distribution perspective, the N.P.C.-U.C.C. tort rule responds to the same pressures as the traditional comparative negligence rule: both seek to avoid the result of leaving losses with negligent plaintiffs when there are negligent defendants. The rules operate differently, however. While the comparative negligence rule apportions only some of the loss to negligent defendants, the N.P.C. leaves all the loss with such defendants. But the N.P.C. leaves all the loss with per se negligent plaintiffs since they can more easily avert losses than generally negligent defendants.

In order to induce settlement and to avoid trials, the N.P.C.-U.C.C. loss allocation rule is preferable to the comparative negligence rule for wire transfer accidents. It avoids the significant possibility of divergent estimates by the parties ex ante of how the court will compare, and thus allocate, fault among litigants.[227] Hard and fast liablility rules produce higher correlations between parties' predictions of litigation outcomes and actual outcomes. The probability of settlement is also increased. Parties are averse to the risk of losing at trial. The prospect of large losses in wire transfer cases heightens that risk. In addition, banks and their corporate customers will seek to avoid the negative publicity that their lack of care or inadequate security measures may foster.

F. *Contracting Out of N.P.C. Rules*

The N.P.C. allows the same broad flexibility as does the U.C.C. to contract out of the effect of its provisions.[228] However, like the U.C.C., the N.P.C. sets some important limits on the power to contract out. Account institutions cannot disclaim responsibility for their lack of good faith or failure to exercise ordinary care or limit the measure of damages. Agreements can, however,

---

P.2d 1162, 1168-69, 144 Cal. Rptr. 380, 386-87 (1978) (Comparative negligence applies to actions founded on strict products liability.).

226. See Brown, Toward an Economic Theory of Liability, 2 J. Legal Stud. 323 (1973); Shavell, Strict Liability Versus Negligence, 9 J. Legal Stud. 1 (1980). See generally R. Posner, Economic Analysis of Law 119-163 (2d ed. 1977).

227. See Shavell, Suit, Settlement and Trial: A Theoretical Analysis Under Alternative Methods For the Allocation of Legal Costs, 11 J. Legal Stud. 55 (1982).

228. N.P.C. § 3(2) (following U.C.C. §§ 1-103, 4-103).

define standards for determining ordinary care as long as the standards are not manifestly unreasonable.[229]

A case can be made that the N.P.C. should permit corporate transactors *total* freedom of contract. The U.C.C., unlike the N.P.C., does not distinguish between freedom of contract for consumer and corporate payments and thus seeks to adopt limits on contracting out that are workable and fair in both cases. Since the N.P.C. does distinguish between consumer and corporate payments and severely restricts freedom of contract for consumers,[230] arguably it should expand freedom of contract for corporations. Nonetheless, in some geographic areas, markets are highly concentrated, and small—or even mid-size—corporate firms may not have realistic alternatives to accepting onerous standard form contractual provisions drafted by account institutions. Since great uncertainty would result from rules limiting contractual freedom on the basis of market concentration—antitrust analysis would be directly imported into the N.P.C.—the N.P.C.'s adoption of the U.C.C. formulation for corporate transactions is appropriate.

The N.P.C.'s contracting-out provisions accomplish four important objectives. First, the ability to contract out underscores the "backstop" role of the N.P.C. If, contrary to the present situation, contracts provided a coherent legal framework for various risks in wire transfer, there would be less need for the N.P.C. The N.P.C. is necessary, in large part, due to the absence of such a contractual structure. Thus, the N.P.C. provides a "backstop" to contracts, coming into play in the absence of contracts; it is not intended to discourage or invalidate appropriate private arrangements. Where, for example, existing transfer system rules adequately address a particular issue, the provisions of those rules will not be displaced. However, where the system rules are silent, the N.P.C. provides the governing body of law.

Second, no general system of rules reaches the best result in all cases. As technology and payment services change over time, the N.P.C. rules may not always produce the most efficient allocation of risk. Parties should be free, within broad limits, to override the N.P.C. rules through contract. This possiblity should not discredit the utility of the N.P.C. rules in a wide range of existing and anticipated systems. In fact, as with the U.C.C., contracting out should generally occur at the margin. Bank card and automated clearing house systems will present a principal exception to this pattern since these systems have comprehensive rules governing interbank obligations. This result is entirely appropriate since these rules are well adapted to the peculiarities of each system.

Like the U.C.C., the N.P.C. allows certain private system rules to be binding on all the parties to a transfer even when they have not specifically assented to those rules.[231] Because securing a consensus of all parties to

229. Id. § 3(1)(b). These limitations are not applicable to transmittors. See supra note 201.
230. N.P.C. § 3(1)(a).
231. Id. § 3(2).

transfers would be extremely difficult, if not impossible, this element of the contracting out provisions is essential to the effective operation of private transfer systems.

Fourth, by broadly legitimating the private contracts of parties to wire transfers, the N.P.C.'s contracting-out provisions place significant limits on the ability of courts to overturn contracts. Contracts between wire transfer providers and their corporate customers currently are subject to various common law attacks, such as adhesion and unconscionability. In the district court opinion in *Evra Corp. v. Swiss Bank Corp.*,[232] the lost-telex case, the court likened a wire transfer advice form, routinely sent by the payor account institution to its customers, to an adhesion contract, and determined that the corporate customer could not have been aware of or have accepted the provisions of such a form.[233] By defining what contracts are acceptable according to their substantive provisions, the N.P.C. prevents such attacks against the validity of contracts. The form of a contract and the bargaining power of the parties involved are irrelevant; instead, all that matters is the content of the contract. Contracts are upheld as long as account institutions do not unreasonably disclaim responsibility for good faith and ordinary care.[234]

One additional issue concerning the validity of contracts requires discussion. Some courts have suggested that fundamental UCC principles of liability cannot be altered by contract, even if they do not exculpate a bank from its good faith and ordinary care responsibilities. The same issue could arise under the N.P.C. In *Cumis Insurance Society v. Girard Bank*[235]—a U.C.C. case—a district court reviewed the validity of Girard's standard form agreement that attempted to assign to its customer, a federal credit union, all responsibility for losses resulting from paying "forged" checks that bore an actual or purported facsimile signature. Although the court based its holding on a determination that the contract did not, by its terms, apply to the particular forgeries involved, it stated in dicta that it had "significant doubt as to the validity of any agreement . . . which seeks to abrogate the fundamental rules of liability for forged signatures which are embodied in the Code."[236] The N.P.C. should reject such a result, whatever the merits of construing the U.C.C. in this manner. If an account institution does not disclaim good faith and ordinary care responsibilities, it should be free to contract with corporate customers as it wishes.

---

232. 522 F. Supp. 820 (N.D. Ill. 1981) (third-party defendant), aff'd, 673 F.2d 951 (7th Cir.), cert. denied, 103 S. Ct. 377 (1982); see supra notes 160–62 and acompanying text.

233. 522 F. Supp. at 832.

234. In addition, the N.P.C. broadly defines the term "agreement" as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance." N.P.C. § 50(15). If advice forms are routinely used, and not objected to, they should become part of the course of dealing between parties.

235. 522 F. Supp. 414 (E.D. Pa. 1981).

236. Id. at 423.

CONCLUSION: THE NEED FOR THE N.P.C.

Currently, trillions of dollars are transferred each year by wire, yet only a bare-bones private contractual structure, with uncertain prospects in the courts, is in place to apportion losses. Neither the U.C.C. nor the EFTA applies to wire transfers, and Regulation J covers only a limited number of risk allocation problems on FedWire. Private system rules generally address only system liability and do little to allocate risks among the parties to transactions. Finally, the common law is too poorly developed to respond to modern problems. Thus, ironically, the payment system transferring the most value is covered by the least adequate body of rules.

Given the significant losses that may ensue, gentlemen's agreements—the traditional method for allocating losses—are no longer reliable. While new insurance policies may protect account institutions from the full brunt of a loss, in fraud or mistake cases an insurance system works best if premiums can be calculated against the background of a system of rules in which risks are identified and assigned. Further, insurance does not always come into play in cases involving authorized orders, where the key issues are whose credit is at stake and who bears the loss from a settlement failure. Moreover, the wire transfer community has recognized the need for rules. As this Article demonstrates, the rules must solve many interrelated problems. The provisions of the N.P.C. applicable to wire transfers fill this void in the law of commercial transactions by providing a systematic body of rules to address these problems.

In the end, one fundamental question must be answered: are we better off with or without the N.P.C.? No code is ever perfect or drafted in accord with everyone's wishes. There is inevitably fundamental disagreement on major matters. Achieving a consensus is further complicated in this case because of the comprehensiveness of the N.P.C. However, this comprehensiveness is also one of its major virtues. The law should not be used as a competitive tool of advantage by the providers and users of particular payment systems. Consistent with the notion of a level playing field on which everyone plays by the same rules, legal costs and risks ideally should be constant for all types of transactions. This notion is not only a matter of fairness, but a matter of efficiency as well. A coherent set of uniform rules would significantly improve the competitive market in payment services. User choice among payment systems should be a function of differing real factor prices, including those attributable to risk, rather than a function of differential costs arising from legally induced inflation or deflation of risk.

This Article, of course, cannot make the full case for the need for the N.P.C. and does not purport to do so. A similar analysis would have to be done for other types of corporate pay orders, such as ACH credit transfers, and for various types of draw orders such as credit cards, ACH debit transfers, and checks. Each of these transactions takes place against the background of different contractual arrangements and statutory provisions. There

is also the complicated matter of consumer rights. Surely, an analysis of this difficult area should be forthcoming as the N.P.C. continues to be examined by the bar and the funds transfer community. A piece of legislation as important as the N.P.C. requires the broadest possible discussion by the parties affected. The principal objective of this Article has been to illuminate one area in which the N.P.C. makes an especially significant contribution.